

DOCUMENT RESUME

ED 293 460

HE 021 373

TITLE State Saving Incentive and Prepaid Tuition Plans with Coordinating Board Recommendations.

INSTITUTION Minnesota Higher Education Coordinating Board, St. Paul.

PUB DATE 17 Mar 88

NOTE 120p.

AVAILABLE FROM Minnesota Higher Education Coordinating Board, Capitol Square Building, Suite 400, 550 Cedar Street, St. Paul, MN 55101.

PUB TYPE Reports - Descriptive (141)

EDRS PRICE MF01/PC05 Plus Postage.

DESCRIPTORS Financial Services; Higher Education; Incentives; *Parent Financial Contribution; Program Administration; Program Costs; *State Programs; Statewide Planning; *Student Costs; *Tuition

IDENTIFIERS *Minnesota; *Paying for College; Savings Accounts; Savings Bonds; Tuition Prepayment; Tuition Savings Plans

ABSTRACT

The benefits, costs, and risks of prepaid tuition and state saving incentive plans to help families pay the cost of a postsecondary education are examined. After discussing why plans have been proposed, financing strategies and savings instruments currently available to families are reviewed. Three types of state plans have emerged: prepaid tuition, savings bonds, and savings accounts. Proposed plans of four states are reviewed briefly. Plans from other sources are also briefly considered, including short-term and long-term institutional prepayment plans, privately-operated plans through nonprofit organizations and commercial groups, and federal plans such as education savings accounts with favorable tax treatment. The possible impact on families and beneficiaries who might participate in plans is considered, along with the effects on postsecondary institutions and state government. Benefits, direct costs, and risks of various state saving incentive and prepaid tuition plans are identified, with attention to the possible impact on families and beneficiaries, postsecondary institutions, and state government. Recommendations of the Minnesota Higher Education Coordinating Board are provided in the concluding chapter. An eight-page bibliography is provided. (SW)

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STATE SAVING INCENTIVE
AND PREPAID TUITION PLANS

with

COORDINATING BOARD RECOMMENDATIONS

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STATE SAVING INCENTIVE
AND PREPAID TUITION PLANS

with

COORDINATING BOARD RECOMMENDATIONS

March 17, 1988

SUBJECT: STATE SAVING INCENTIVE AND PREPAID TUITION PLANS

DATE: MARCH 17, 1988

ACTION: THE HIGHER EDUCATION COORDINATING BOARD ADOPTED THE FOLLOWING
RECOMMENDATIONS

1. That if the Minnesota Legislature establishes a state savings plan, the Higher Education Coordinating Board, based on the knowledge gained from its extensive study of prepaid tuition and saving incentive plans, actively participate in the development of the plan, which should:
 - a. be applicable to a wide range of post-secondary institutions within and outside the state;
 - b. be applicable to all levels of post-secondary education, from sub-baccalaureate through graduate and professional;
 - c. provide some measure of equity by limiting the amount that participants can save in the program;
 - d. be developed in the context of state policies outside post-secondary education that might be affected;
 - e. be presented to prospective participants in terms that make clear the financial risks and benefits; and
 - f. complement either proposed federal savings plans or suitable plans developed by the private sector.
2. That the Higher Education Coordinating Board continue to examine the need analysis for state financial aid programs to determine if adjustments should be made in the way parental savings affect qualifications for awards; further, the Coordinating Board and the post-secondary education community in Minnesota seek to have the federal government undertake similar action for its student financial aid programs.
3. That the legislature and governor not enact a state plan for prepaid tuition at Minnesota's institutions of post-secondary education.
4. That the Higher Education Coordinating Board seek funds for a campaign to inform families about the cost of post-secondary education and to encourage them to plan for that cost.

OVERVIEW OF RECOMMENDATIONS
ON STATE SAVING INCENTIVE
AND PREPAID TUITION PLANS

Background and Rationale

The Higher Education Coordinating Board included in its Management Plan for 1986-89 a study of saving incentives for post-secondary education. In May 1987, the Board expanded the study to include prepaid tuition plans. The staff report, State Saving Incentive and Prepaid Tuition Plans, examines whether any plan that has been established or proposed is appropriate for Minnesota to adopt.

CONCLUSIONS

Three types of state plans have emerged: prepaid tuition, savings bonds, and savings accounts. Each type of plan has benefits, costs, and risks for participants, post-secondary institutions, and state government. Analysis of plans has led to the following conclusions:

- o Prepaid tuition--A prepaid tuition plan would place all parties at considerable risk. Each party involved in a plan faces the possibility of financial loss. Other consequences might include inappropriate educational choices by participants, loss of enrollments by some post-secondary institutions, and loss of credibility by the state for not delivering promised benefits.
- o Savings bonds--A state savings bond program would leave participants responsible for purchasing enough bonds to pay the cost of a post-secondary education. While risks to participants and institutions would be small, the state might incur costs related to issuance of bonds and debt management.

o Savings accounts--Savings accounts also would leave participants responsible for covering educational costs. Otherwise, participants and institutions would face little risk. Tax advantages with such accounts would be a cost to the state in the form of foregone tax revenues. The absence of similar tax advantages at the federal level, however, might deter participation in a state program.

Assessment of state saving incentive and prepaid tuition plans requires other considerations. Enactment of a federal plan or development of plans in the private sector might make a separate state plan unnecessary. No plan, however, would replace need-based financial aid because participants in each come from different populations. Further, early saving by families for post-secondary education remains a key element in any financing strategy.

BOARD RECOMMENDATIONS AND RATIONALE

Based on the conclusions of the study State Saving Incentive and Prepaid Tuition Plans, and recent information regarding federal initiatives, the Higher Education Coordinating Board on March 17, 1988 adopted the following recommendations.

1. That if the Minnesota Legislature establishes a state savings plan, the Higher Education Coordinating Board, based on the knowledge gained from its extensive study of prepaid tuition and saving incentive plans, actively participate in the development of the plan, which should:
 - a. be applicable to a wide range of post-secondary institutions within and outside the state;
 - b. be applicable to all levels of post-secondary education, from sub-baccalaureate through graduate and professional;
 - c. provide some measure of equity by limiting the amount that participants can save in the program;

- d. be developed in the context of state policies outside post-secondary education that might be affected;
- e. be presented to prospective participants in terms that make clear the financial risks and benefits; and
- f. complement either proposed federal savings plans or suitable plans developed by the private sector.

Rationale

A state savings plan for post-secondary education should have the following features:

- o The plan should apply to the widest possible range of post-secondary institutions in order to provide the widest possible educational choice for participants. Assets, thus, should be applicable at virtually all post-secondary institutions, public and private, collegiate and vocational, within and outside Minnesota.
- o The plan should apply to all levels of post-secondary education, from sub-baccalaureate through graduate and professional. Advanced study beyond the bachelor's degree typically is much more expensive than undergraduate study. Families and individuals should have the opportunity to accumulate and use assets in a savings plan to cover these costs.
- o The plan should be equitable by limiting the distribution of benefits. It should not be an open-ended tax shelter that provides the greatest benefits to the wealthiest families. Methods to accomplish this could include placing ceilings on the amounts contributed to a plan and on incomes for eligible families.
- o The plan should be developed within the context of other state policies. Establishment of savings accounts with favorable tax treatment should include careful consideration of the impact on the trend toward tax simplification and elimination of tax expenditures. Similarly, creation

of savings bonds should occur only after careful attention to the state's debt management policy.

- o State action to complement a federal savings plan would have two advantages. First, it likely would simplify and encourage participation by Minnesota residents in a plan. Second, it likely would simplify matters for the state in areas such as tax treatment of assets placed in a plan.

The state also might wish to encourage participation in private plans designed to help pay the cost of post-secondary education. In that event, the state would have to determine what incentives for participation would be offered and what plans would qualify for those incentives.

Before adopting measures along these lines, however, the state should consider fiscal circumstances and the impact on related state policies.

The Board recognizes the interest expressed by the executive and legislative branches in considering the authorization of a state savings plan. During the past year the Board has studied extensively the benefits, risks, and costs of prepaid tuition and saving incentive plans. The Board would be able to contribute this background to the development of a plan that meets the needs of citizens in planning for future post-secondary expenses. Further, the Board has extensive experience in developing and administering programs to assist students and families in financing post-secondary education.

Persons considering participation in a state savings plan need to understand the advantages and disadvantages of such a program and what it will mean for their financial situations.

Families need to know how the benefits of a state savings plan compare to alternative investment options that they might pursue in planning to finance post-secondary education.

Impact

The fiscal impact would depend on the nature of the plan. A savings bond plan likely would involve the state assuming additional administrative costs associated with the sale of bonds and, perhaps, a bonus patterned after the one included in the Illinois plan. A savings account plan likely would reduce state revenues through exemptions, credits, or deferments for contributions and earnings. The amount of reduced revenue would depend on prevailing tax rates and the extent of participation.

2. That the Higher Education Coordinating Board continue to examine the need analysis for state financial aid programs to determine if adjustments should be made in the way parental savings affect qualifications for awards; further, the Coordinating Board and the post-secondary education community in Minnesota seek to have the federal government undertake similar action for its student financial aid programs.

Rationale

The impact of savings on qualification for Minnesota student financial aid programs deserves study regardless of a possible savings plan for post-secondary education. At issue is whether the current need analysis might give parents who do not save higher monetary awards than those given to parents with comparable income who do save. Rewards to parents who do not save would imply disincentives for other parents to save for a child's education. The findings of a study might indicate whether changes in the need analysis would be desirable.

Similar action at the federal level could result in consistent treatment of savings in federal and state financial aid programs.

Impact

As an ongoing Board activity, the project would require no additional state funds.

3. That the legislature and governor not enact a state plan for prepaid tuition at Minnesota's institutions of post-secondary education.

Rationale

A state prepaid tuition plan would place too many parties at risk. Unless the rate of return on invested funds and the rate of increase in tuition were identical, someone would have to pay the difference between them. In case of an investment surplus, participants might lose the extra return. In case of a deficiency, participants might lose benefits or pay higher premiums.

Post-secondary institutions might lose tuition revenue, or their students who are not participants in a plan might have to pay higher tuition to provide expected tuition revenue. The state might have to increase tax revenue or divert funds from other programs.

Other risks would arise. Restrictions and inducements on choice of institutions might lead students to make inappropriate educational choices. Some post-secondary institutions also might be affected adversely by the diversion of students who feel obligated to attend a certain institution in order to redeem benefits. Various state policies for financing post-secondary education might be undermined, while questions about access to programs in the state might arise. Beyond this, the credibility of the state could be at risk either by failure of the plan to provide promised benefits or by use of state funds to provide benefits despite promised self-sufficiency of the plan.

Impact

No direct fiscal impact on the state would occur.

4. That the Higher Education Coordinating Board seek funds for a campaign to inform families about the cost of post-secondary education and to encourage them to plan for that cost.

Rationale

Students and their families have the primary responsibility for paying the cost of attending post-secondary institutions. The state can help families plan to meet this cost through encouragement of saving. The act of saving is more important, at least initially, than the particular savings instrument, though many vehicles for saving are available. For most families and individuals, savings alone likely will not cover the entire cost of attendance. Savings, however, can be an important part of a financing strategy that includes current income and loans.

The earlier families begin to plan for post-secondary education, the stronger will be their financial situation at the time of attendance. Families with children of kindergarten age or younger would benefit most. An ongoing information campaign directed at these families to encourage saving and to explain savings options, thus, would be an important service. Such a campaign could be an extension of the Coordinating Board's existing and planned efforts to communicate with parents of eighth grade students regarding plans for post-secondary education.

Impact

Administration of the campaign would require additional operating funds for the Coordinating Board. Direct state funding would involve new and continuing appropriations. Support from non-government sources also might be feasible.

EXECUTIVE SUMMARY

Several states recently have enacted a saving incentive or a prepaid tuition plan to help families pay the cost of a post-secondary education. Other states are considering action. Interest in state plans and plans from the federal government and private organizations has developed because of trends in educational costs and personal finance.

In 1987, the Minnesota Higher Education Coordinating Board directed its staff to study state saving incentive and prepaid tuition plans. The study examines the benefits, costs, and risks of three types of state plans:

- o prepaid tuition
- o savings bonds
- o savings accounts

The study explores the possible impact on parties most directly affected by a plan: participants, post-secondary institutions, and state government.

PREPAID TUITION

A prepaid tuition plan would provide the opportunity for significant benefits to participants at potentially little cost to the state, but it would place all parties at considerable risk. Participants might incur a financial loss and make inappropriate educational decisions. Some post-secondary institutions might lose enrollment, while others not losing enrollment might lose revenue. The state might need to pay for a financial deficiency or risk its credibility by not delivering promised benefits.

SAVINGS BONDS

With a state savings bond program, the participant would have to anticipate educational costs and purchase bonds to cover them. Risks to participants and to post-secondary institutions would be minimal. The state would incur direct

administrative costs from the issuance of bonds. It also might encounter costs related to debt management.

SAVINGS ACCOUNTS

Savings accounts with tax advantages would present few risks to participants and post-secondary institutions, though accumulated assets might fall short of educational costs. The state would incur the cost of foregone revenue from the tax advantages to participants. Without similar tax treatment by the federal government, however, participation in a state program might be low.

OTHER CONSIDERATIONS

Other elements are important in assessing state saving incentive and pre-paid tuition plans. Enactment of a federal plan might make a separate state plan undesirable. A federal plan would apply throughout the country, and it might be incompatible with a state plan. Plans offered by private organizations might suit the needs of state residents. No government or private plan, however, would be a replacement for need-based student financial aid because a plan and financial aid would serve two different populations. Whatever plans eventually emerge, the immediate challenge is to encourage families to begin saving for post-secondary education early.

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CHAPTER I. INTRODUCTION

Concern over the ability to pay for an individual's post-secondary education has led to interest in saving incentive and prepaid tuition plans. Saving plans are designed to encourage the accumulation of money to cover an individual's expenses at the time of attendance. Prepayment plans involve the purchase of education services at current or discounted prices before attendance.

In late 1986, one observer wrote that prepaid tuition would "spread like a prairie fire."¹ Plans recently established by private colleges, namely Duquesne University and Calvin College, were receiving wide publicity as a means for families to beat the high cost of a child's college education. The idea's popularity prompted efforts in government and the private sector to establish plans.

Much attention has focused on proposals for state governments to establish plans. In December 1986, Michigan became the first state to enact legislation establishing a plan for tuition prepayment. During 1987, five more states--Florida, Indiana, Maine, Tennessee, and Wyoming--did the same. Two other states, Illinois and North Carolina, established saving incentive plans in the form of state savings bonds. Legislatures in two states, California and West Virginia, passed measures that the governors subsequently vetoed. In all, more than 40 states, including Minnesota, have considered proposals for saving incentive or prepaid tuition plans. Activity also has occurred in the federal government and the private sector. Several bills to establish federal savings plans have been introduced in Congress, and several candidates for president have expressed interest in a federal program. Private organizations, commercial

¹ Jane Bryant Quinn, "Colleges Adopting Pay-Now, Attend-Later Plans," St. Paul Pioneer Press Dispatch (December 2, 1986).

and non-profit, are offering or preparing to offer plans dedicated specifically to financing post-secondary education.

Tuition prepayment plans have aroused controversy. Advocates view them as a necessary means of planning for the financing of an individual's post-secondary education. Critics have reservations about their value and effectiveness as a financing tool.

The Minnesota Higher Education Coordinating Board included a study of college savings plans in its 1986-89 Management Plan. The scope of the project was expanded in spring 1987 to include tuition prepayment plans when they became an issue in post-secondary education finance.

This study examines various plans that have been established and proposed. The purpose is not so much to determine which plan is the best but to determine whether any are appropriate for the state to adopt or endorse. Two major policy questions arise:

- o What should be the nature and degree of involvement of state government in educational saving and tuition prepayment plans?
- o How might the existence of state-sponsored plans affect other state policies for post-secondary education such as institutional funding and student financial aid?

Reasons for the interest in saving incentive and prepaid tuition plans are identified and discussed. The focus of the report, however, is on the various plans rather than the reasons for them.

The introduction is followed by eight chapters. The next chapter discusses why interest in plans has grown. It is followed by a chapter on the role of families and individuals in financing post-secondary education. Two chapters examine the nature and features of various plans. The subsequent three chapters address who could be affected by a state plan and how. Conclusions appear in the final chapter.

CHAPTER II. WHY PLANS HAVE BEEN PROPOSED

Interest in saving incentive and prepaid tuition plans reflects anxiety about the ability of families to pay the cost of a post-secondary education. This anxiety has resulted from a convergence of events and circumstances. Among these are rising costs of education, rising levels of student debt, questions about access to education loans, decreasing rates of saving by families, and elimination of tax incentives used by parents to save for a child's education.

COST OF POST-SECONDARY EDUCATION

The cost of post-secondary education has two dimensions. One is the cost of attendance, which is incurred by students and their families. Tuition constitutes a large portion of the cost of attendance, though living expenses and other items contribute significantly to a student's costs.

The other dimension of educational cost is operating costs incurred by post-secondary institutions to provide instruction and related services. Many, but not all, of these costs are passed along to students in the form of tuition and fees.

Cost of Attendance

Questions about the ability of families to pay the cost of attendance have caused concern reflected in coverage of the issue by the news media. Estimates that the cost of a four-year college education might exceed \$100,000 around the year 2000 have increased anxiety. Such discussion, however, often ignores the likelihood of family income rising with tuition and other elements of the cost of attendance in the future.

Developments nationally since 1970 provide perspective on the issue of affordability. In recent years, disposable income has increased more slowly

than tuition and fees. Between 1980-81 and 1986-87, disposable income increased at an average annual rate of 6.5 percent compared to a 9.8 percent increase in tuition and fees. Increases in tuition and fees varied by type of institution. Over the long term, though, increases in disposable income and the cost of attendance have not diverged widely. Between 1970-71 and 1986-87, disposable income increased at an average annual rate of 8.2 percent compared to increases in tuition and fees of 7.8 percent.²

Other analyses yield similar findings. One study indicates that the financial burden of public higher education on families remained relatively stable from the mid-1970s to the mid-1980s. For families with dependents age 18 to 19 in college, the price of public higher education as a percent of median income did not change significantly. The price of a private education as a percent of median income did increase, however.³ Another study indicates that from 1970-71 through 1985-86 disposable personal income per capita nationally increased at a greater rate than the cost of attending all types of collegiate institution except private universities.⁴

²-----
Arthur Hauptman and Terry Hartle, "Tuition Increases Since 1970: A Perspective," Higher Education & National Affairs (February 23, 1987), p. 5. These data are derived in a different manner from tuition data on Minnesota's public post-secondary systems presented in Chapter VIII. The two sets of data, thus, are not compatible.

³ Terry W. Hartle, "Beneath the Surface: College is Not as Costly as it Seems", Educational Record, 67 (Spring-Summer 1986), pp. 16-19. According to the data in the article, median income of families without dependents age 18 to 19 in college did not rise as fast as income of families with such dependents. The possibility exists that families with lower income could not afford to support children in college. Thus, only families with rapidly rising incomes could afford college education. The data cited do not indicate whether the proportion of families with dependents in college increased relative to the number with dependents not in college.

⁴ Janet S. Hansen, Student Loans: Are They Overburdening a Generation? (The Washington Office of the College Board, February 1987), p. 27.

Operating Costs

Institutional operating costs help determine the price of tuition and fees charged to students. The connection is quite clear at private institutions where tuition typically accounts for the majority of operating revenues. Even at public institutions supported primarily by government appropriations, tuition often is related to operational costs. In Minnesota's public post-secondary systems this relationship is explicit. The state appropriates funds to cover 67 percent of estimated instructional costs at collegiate institutions. Other revenues, primarily tuition, account for the remaining 33 percent. At technical institutes, the respective percentages are 74 and 26. Tuition, thus, rises or falls with the cost of institutional operations.

Colleges and universities have been criticized for not exerting enough control over operating expenditures. Some observers have argued that institutions have been able to pass along the costs to students and their families who so far have been willing to pay higher tuition.⁵ Other observers have justified rising expenditures as redress for sacrifices to inflation made during the late 1970s in faculty salaries, equipment, library acquisitions, and building repairs. Improvement in the quality of education also is cited as a major reason for higher costs.⁶

⁵-----
See, for example, Richard E. Anderson, "Fuming Over College Costs," Newsweek (May 18, 1987), pp. 66-71; Carol Innerst, "Schools Under a Spending Spotlight", Insight, a magazine of The Washington Times (June 1, 1987), pp. 52-53; and Thomas P. Melady, "To Solve a Higher Education Dollar Squeeze, Open the Books," Minneapolis Star and Tribune (Aug. 21, 1987), p. 17A.

⁶ See, for example, Robert H. Atwell and Arthur M. Hauptman, "The Politics of Tuition," Educational Record, 67 (Spring-Summer 1986), pp. 4-6; Sheldon Hackney, "Under the Gun: Why College is So Expensive," Educational Record, 67 (Spring-Summer 1986), pp. 9-10; and Cathy Henderson, "Forecasting College Costs Through 1988-89," Educational Record, 67 (Spring-Summer 1986), pp. 25-29.

STUDENT DEBT

Another source of concern is the substantial increase in student debt during the 1980s.⁷ According to observers, too many individuals are committing to debt payments too much of their future income for their own well-being. The perceived problem does not rest with students from middle-income families pursuing baccalaureate degrees. Most concern is directed at students from low-income families who might not realize the burden of their debt. Another group with increasing levels of debt is graduate and professional students. Default rates on loans, according to initial analysis, are highest among individuals with small loans attending two-year colleges or vocational schools. A study by the Coordinating Board of debt levels and default on student loans in Minnesota is in progress.

AVAILABILITY OF LOANS

Obtaining loans is a problem for some middle-income families. Restrictions on income levels placed on the federal Guaranteed Student Loan (GSL) Program in 1981 and 1986 have contributed to this. One observer has stated that the GSL program changed "from a program intended mainly to ease the cash-flow problems of non-needy families to a major source of funds of low-income students attempting to pay for college."⁸

To address this situation, several states have established supplemental loan programs. In Minnesota, the Student Educational Loan Fund provides loans to students who are ineligible for federal loan programs or who need additional funds to pay the cost of attendance. Loans also are available specifically to graduate and professional students.

⁷-----
⁸ This is a major theme of Hansen, Student Loans.
Ibid., p. 10.

FAMILY SAVINGS

Families appear to be saving less now than in the past. In 1986, personal saving as a percent of disposable income in the United States was 3.8 percent. This was a low point in a 25-year rise and decline in the national saving rate. From 1961 to 1975, the rate increased from 6.3 to 8.6 percent, followed by a decline to the 5 to 6 percent range in the early 1980s.⁹ Recent research further indicates that, compared to earlier generations, adults born after 1940 have a low saving rate during a period in their lives when they should be reaching a peak in saving.¹⁰

The results of a nationwide survey published in 1984 indicate levels of parental saving for a child's post-secondary education.¹¹ According to the survey, about 50 percent of parents who expect to have their children go to college save for that purpose. The median amount saved per year among those who do save is \$517. As seen in Table 1, amounts saved annually increase with household income and age of children.

Patterns of saving could change. The precipitous decline of the stock market in October 1987 has led to speculation that individuals will be more cautious financially. The result might be a reduction in personal spending and an increase in saving.

CHANGES IN TAX LAWS

Until federal tax laws were revised in 1986, parents could save for a child's post-secondary education while receiving favorable tax treatment.

⁹-----
U.S. Department of Commerce, Business Statistics 1984 (U.S. Government Printing Office, 1985), p. 2; U.S. Department of Commerce, Survey of Current Business, vol. 87, October 1987 (U.S. Government Printing Office, 1987), p. S-1.

¹⁰ Susan F. Rasky, "A New Generation of Non-Savers," New York Times (November 2, 1986), pp. 1, 12.

¹¹ North Carolina Commission on Higher Education Facilities, A National Study on Parental Savings for Children's Higher Education Expenses (National Institute of Independent Colleges and Universities, 1984), pp. 10-11.

TABLE 1. SAVING PATTERNS OF PARENTS PLANNING TO HELP PAY
THEIR CHILDREN'S COST OF ATTENDING COLLEGE, 1984

	Percent Currently Saving for Children's College Education	Median Amount Now Saved Per Year
All parents expecting children to attend college	51%	\$ 517
By household income		
Under \$10,000	17%	\$ 120
\$10,000 - \$19,999	45%	\$ 140
\$20,000 - \$29,999	52%	\$ 466
\$30,000 and over	70%	\$ 904
By age of children expected to go to college		
Under 13	51%	\$ 443
Age 13 - 18	58%	\$ 500

SOURCE: North Carolina Commission on Higher Education Facilities, A National Study on Parental Savings for Children's Higher Education Expenses (National Institute of Independent Colleges and Universities, August 1984), page 11.

Federal law allowed for annual contributions to an account in the name of a minor child through such vehicles as Clifford Trusts and the Uniform Gifts to Minors Act. Taxes on earned interest were assessed at the child's tax rate, which was zero in the absence of other significant income.

The revised law provides for taxation of annual interest earnings above \$1,000 at the parents' tax rate. This restriction on tax-free earnings has led parents and financial analysts to look for other vehicles with favorable tax treatment, such as insurance policies. Saving incentive and prepaid tuition plans fit in this category.

Two further changes in federal tax law that directly affect post-secondary students also have aroused some concern. One is an end to deductions for interest on education loans and most other consumer loans. The other is the extension of taxation to portions of scholarships and grants that exceed the price of tuition and required fees.

SUMMARY AND CONCLUSION

Several trends and developments have stimulated interest in new financing instruments, including prepaid tuition. The cost of attendance rose considerably in the early 1980s. If long term trends continue, however, the cost might not significantly outpace increases in family income. Operational costs at post-secondary institutions likewise have increased, but whether they will continue to increase at recent rates is not clear. In any event, increases in family savings will not reduce costs. If anything, availability of savings might help make increases in tuition and other costs easier for students and their families to accept.

Student debt has been increasing, and with it the burden on future income and the risk of default. Most concern is directed at the burden on students from lower-income families. These families, however, may not be in financial

position to increase saving as an alternative to borrowing. Meanwhile, the federal government has reduced the availability of loans for middle-income students. In response, several states, including Minnesota, have established programs to provide greater access to education loans.

Personal saving rates in the United States have been declining since the mid-1970s. Saving rates appear to be especially low among adults under age 45, the group most likely to have children approaching college age. This trend was well established before the 1986 federal tax law eliminated advantageous treatment of some savings. What might finally reverse the trend is a profound change in outlook for the economy.

CHAPTER III. FINANCIAL ROLE OF FAMILIES

Attention given to saving incentive and prepaid tuition plans underscores the major responsibility that families continue to have in financing an education. This chapter reviews basic financing strategies and savings instruments that currently are available to families. The focus here and throughout the study is on saving as a means of financing the cost of attending a post-secondary institution.

FAMILY FINANCING STRATEGIES

Post-secondary education is one of the largest purchases most individuals and families make. Financing a major purchase frequently is easiest when planned over the long term. Absence of long-term planning for the financing of post-secondary education, however, is common. Evidence of this appears in surveys showing that many families do not know how much a college education costs.¹² More persons overestimate the cost than underestimate it. In any event, a good estimate of anticipated cost is a prerequisite for effective planning.

Families and individuals have essentially three ways of financing a post secondary education: paying as they go, borrowing, and saving. The three are not mutually exclusive. Many families, by long-term design or short-term expediency, combine all of them.

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Rhonda J. Dixon, Parents of Illinois Eighth Graders: A Survey of Their Knowledge About Academic and Financial Planning for Their Child's Education Beyond High School (Illinois State Scholarship Commission, 1987), pp. 6-7; Jean Evangelauf, "Many Americans Think College Costs Much More Than It Actually Does, A Chronicle Survey Finds," The Chronicle of Higher Education (September 2, 1987) pp. A1, A70; and Lorayn Olson and Rachel A. Rosenfeld, "Parents, Students, and Knowledge of College Costs," Spencer Foundation (1984).

Paying As One Goes

Families can use current income, including scholarships and grants to students, to pay educational and related costs during the time of attendance. Much of the concern over the rising cost of attendance reflects difficulties in paying the cost from current income. Paying as one goes assumes that current income is sufficient to cover the cost of attendance plus other obligations. This approach, however, would tend to restrict educational choice. The cost of attendance at post-secondary institutions often is too high for families to pay from annual income.

Committing Future Income

If current income and available assets are insufficient to pay the cost of attendance, families and students can borrow money. In doing so, they commit future income, thereby limiting future consumption and, perhaps, the ability to help pay for the education of the next generation. Concern has arisen over the magnitude of debt. There also is some concern about the availability of government-subsidized loans.

Saving

Savings are the accumulation of past income for future consumption. Use of savings is a traditional approach to help make major purchases such as homes and automobiles. Paying for a child's education with savings requires the foregoing of spending on goods and services by one generation in order to provide for the education of the next. With savings, families can reduce the burden on current income and reliance on borrowing. Plans for savings and prepaid tuition are attempts to encourage saving as a way for families to finance the cost of post-secondary education.

SAVINGS OPTIONS

A variety of options are available for families wishing to save for any reason, including post-secondary education. Growing concern over future costs of education and recent changes in tax laws have brought renewed attention to these options.¹³ Savings vehicles include savings accounts, stocks, bonds, annuities, and certain types of life insurance policies. Favorable tax treatment frequently is possible to arrange. Families assume responsibility for anticipating the cost of attendance and structuring their finances accordingly. Families may seek the advice of professional financial planners for such matters.

Two key elements are the same in any savings strategy: the amount and the duration of savings. The more a family saves and the earlier it begins to save, the more money will be available when a child is old enough to attend a post-secondary institution.

Savings Accounts

Passbook savings accounts and certificates of deposit often are used to accumulate funds, especially if saving is persistent over a period of time. Required deposits to open an account usually are small. Income from interest is taxed at the account owner's tax rate. If funds are in a custodial account under the federal Uniform Gifts to Minors Act, the first \$500 of interest income per year is not taxed. The next \$500 is taxed at the child's income tax rate, which usually amounts to no federal tax because most children do not earn enough to make them subject to taxation. If the child is under age 14 and earnings exceed \$1,000 per year, the excess is taxed at the parents'

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See, for example, Linda Owen, "How to Beat the Cost of College", St. Paul Pioneer Press Dispatch (April 28, 1987), pp. 1B, 4B; and "Best-Rated Tax-Free Investments," Consumer Guide, 462 (1987).

rate. At federally insured savings institutions, deposits are insured up to \$100,000 per depositor.

Series EE U.S. Savings Bonds

U.S. Savings Bonds are available in denominations with face values as low as \$50. If held for at least five years, they earn a minimum of six percent interest guaranteed by the federal government. If bonds are purchased for a child and redeemed after the child reaches age 14, the proceeds are taxed at the child's tax rate. Again, this likely would result in payment of no taxes.

Municipal Bonds

Municipal bonds are sold by state and local governments. Usually the lowest denomination is \$5,000 on which interest is paid over the term of the bond. Some investment funds based on municipal bonds are available with lower minimum investments, but service fees could be significant. Owners needing cash may sell the bonds at any time, but their market value will vary depending on prevailing interest rates. In many instances, the issuer reserves the right to call the bonds; that is, redeem them earlier than scheduled. Interest earnings from municipal bonds are exempt from federal income tax. Minnesota residents are exempt from paying income tax on earnings from Minnesota municipal bonds, but they must pay taxes on non-Minnesota bonds.

Zero-Coupon Bonds

Zero-coupon bonds are sold at a fraction of their face value but redeemed at face value. Although interest earnings are deferred until maturity, taxes are paid annually on the estimated earnings. Zero-coupon municipal bonds, however, are tax-exempt. Funds invested in a zero-coupon bond are tied up until maturity.

Stocks

Stock accounts, like savings accounts, can be placed in a child's name. Tax treatment also would be similar. Stocks, however, are riskier because their value can fluctuate dramatically. Their value might decline when funds are needed to pay for a child's post-secondary education. Effective investment in stocks, moreover, requires continuous, expert management.

Life Insurance

Whole-life insurance is a form of savings. Premiums paid on behalf of the policy holder accumulate and earn interest until the face value of the policy is reached. Interest earnings are tax free. Upon maturity, the proceeds become available to the policyholder typically for use during an individual's retirement. Before maturity, however, the policyholder may borrow from accumulated funds for any purpose, including a child's post-secondary education.

Many insurance companies offer single-premium life insurance. This involves payment of a single premium at the time of purchase. The large premium frequently required for such policies might be too great for many families to afford. Policies can be written in either a child's or a parent's name, whichever is perceived to be advantageous. The policyholder then may borrow against the increased cash value above the initial premium for any purpose. Depending on the policy, interest rates on the amount borrowed could range from zero to several percent. Some policies might not require repayment. Any borrowed funds that remain outstanding would be deducted from the proceeds when the policy is cashed in.

Single-Premium Tax-Deferred Annuities

Insurance companies also offer single-premium tax deferred annuities. Companies offer annuities for a single premium paid at the time of purchase. Taxes on earned interest are deferred until the annuity matures. Annuities are

used primarily for retirement when an individual's tax rate is likely to be low. They also may be purchased on a child's behalf for use after age 14 when the child's earnings are taxed separately from parental earnings.

SUMMARY AND CONCLUSION

Families traditionally have assumed responsibility for helping to finance an individual's post-secondary education. Public policy, moreover, expects this. Families can pursue one or a combination of three strategies to help pay the cost of attendance. They can use current income. They can borrow money and repay it from future income. They can save money and pay the cost of attendance from past income.

A variety of financial instruments are available to help families save for a post-secondary education. Some of these, such as savings accounts, stocks, and U.S. Savings Bonds, may be subject to taxation at the tax rates of parents. Others, such as zero-coupon bonds, municipal bonds, annuities, and life insurance policies, have or can be structured to have more advantageous tax treatment.

CHAPTER IV. STATE SAVING INCENTIVE AND PREPAID TUITION PLANS

Saving incentive and prepaid tuition plans may have a variety of forms and features. This chapter defines and describes plans, reviews features of plans that states have enacted, and describes features of several plans under consideration in other states.

DEFINITIONS

Saving and tuition prepayment are two distinct forms of investment. Differences involve the nature of goals, benefits, and risks. Plans for one or the other reflect these distinctions. Some attempts have been made to combine the two as options under a single plan.

Saving Incentive Plans

Most savers place their money in savings accounts, stocks, bonds, investment funds, or other financial instruments that yield interest. There are no guaranteed benefits other than guaranteed returns on certain interest-bearing instruments. If saving is directed toward a specific goal, the saver bears the risk of not accumulating enough resources to attain it. Individual savers largely determine the amounts of accumulated funds through size of deposits, persistence and duration of saving, ability to take advantage of tax laws, and willingness to take risks.

Saving incentive plans provide an inducement and structure for savers to pursue their goals. Plans frequently have limits on the amount and use of savings. The broad intent is to encourage systematic saving for a specific purpose that might not otherwise occur. Inducements may take different forms. Widely known inducements include tax exemptions, tax credits, and tax deferments

on principal, earned interest, or both. Another approach is full or partial matching of a saver's contributions by another party.

The Individual Retirement Account is an example of a saving incentive plan. It provides tax deferments as an incentive for individuals to save for retirement using a variety of investment instruments. Several restrictions on IRAs exist, however. Income ceilings limit eligibility for some tax deferments; the amount of annual contributions is limited; a penalty for withdrawal before the saver reaches a specified age restricts the use of funds; and mandatory commencement of withdrawals by a certain age limits the duration of the plan.

Prepayment Plans

Prepayment is the purchase of a good or service to be provided in the future. It guarantees a benefit to the purchaser at an agreed price in the present, thus providing insurance against future price increases. It also provides current income to the seller who can invest the proceeds prior to delivery of the benefit.

Risks to both parties exist in prepayment. For the purchaser, the need or value of the benefit might diminish by the time the benefit becomes available. For the seller, the cost of providing the benefit might be higher than the price charged plus interest earned on the money during the interval between prepayment and delivery.

Attrition is an important element in many prepayment plans. Not all purchasers of a prepaid benefit claim it. Although individuals not claiming a benefit might receive a refund, they also might have to forfeit real or imputed interest earnings, pay a penalty, or both.

When providers of benefits can anticipate attrition rates, they also can anticipate additional funds from forfeitures and penalties. Providers have several options in the use of these funds. They can discount the purchase price

of the prepaid benefit in anticipation of compensating revenue from attrition. They can accumulate the funds for use as a reserve against unforeseen developments. They also can spend the funds on operations or distribute them as profits.

Prepayment plans involve formal agreements or contracts between parties. Beyond specifying payments and benefits, an agreement may specify penalties in the case of the purchaser not accepting or the seller not providing the benefit. An agreement also may stipulate time limits for acceptance or delivery of benefits and circumstances under which either party may withdraw. Upon mutual agreement, the terms and benefits of plans may be subject to change.

A variety of goods, services, and other benefits are available through prepayment. Most prepayment arrangements apply to a relatively short period of time. Examples include care from health maintenance organizations, service contracts for appliances, and discounted air fares. One example of a long-term arrangement is prepaid funerals. Life insurance and retirement funds are examples of prepayment for a guaranteed monetary benefit. Proceeds from insurance, however, will not necessarily be sufficient to secure a good or a service.

The concept of prepaid tuition received public attention as early as 1977. A proposal at that time was directed at private colleges, emphasizing two benefits to institutions. One was to provide private colleges with a source of funds for investment and operations. The other was to guarantee future enrollments.¹⁴

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Ben W. Bolch and C. Elton Hinshaw, "A Prepaid Tuition Plan for Private Higher Education," Journal of Education Finance, vol. 3 (Summer 1977), pp. 101-06.

EXISTING STATE PLANS

As of the writing of this report, the governments of eight states had enacted plans for prepayment of tuition or saving for post-secondary education. Six states, Florida, Indiana, Maine, Michigan, Tennessee, and Wyoming, have prepayment plans. Michigan's plan, enacted in December 1986, is a prototype that other states adopted with modifications. Only Wyoming's plan has been implemented. The remainder are awaiting establishment of administrative procedures and rulings by federal agencies regarding taxes and investments. None of the states had actuarial studies completed prior to enactment of plans, though some studies are in progress. Consequently, questions related to required length and return on investments, required number of participants, and price to participants have not been resolved. In most instances, specific terms, conditions, and procedures are left to the determination of the agency assigned responsibility for the plan.

Two states, Illinois and North Carolina, have saving incentive plans in the form of savings bonds. The Illinois plan creates state savings bonds to pay the cost of attending a post-secondary institution. The state has authorized setting aside \$300 million of initial principal from future issues of its general obligation bonds to be sold as zero-coupon bonds. The initial sale of bonds was scheduled for January 11, 1988. The North Carolina plan has not proceeded beyond authorizing the use of state bonds as savings bonds.

The following material summarizes features of the plans.

Coverage

All six prepayment plans are designed to cover resident tuition and fees for a bachelor's degree at public colleges and universities within the respective states. Graduate and professional studies are not covered. Most of the plans make specific provision for use of benefits at two-year institutions. The

Wyoming plan allows for prepayment of nonresident tuition and fees. Prepayment of housing costs is available in Florida and Wyoming.

In Illinois, proceeds from mature bonds may be used for any purpose by the bondholder, educational or noneducational. If the proceeds are used for payment of tuition and required fees at an authorized post-secondary institution in the state, the state could increase final payment to the bondholder by up to one half of one percent per year for the term of the bond, payable upon maturity. For its initial issue of bonds in January 1988, Illinois expects to set the rate of this increased payment at .4 percent. The increased yield may not be given for attendance at a seminary or for preparation of a member of the clergy. The legislation otherwise does not appear to place limitations on applying the benefits to graduate or professional studies.

Purchase Unit

The unit of coverage for sale to the purchaser has been determined in only two states. In its tuition prepayment plan, Florida provides for the sale of individual credit hours up to the number required for a degree. Housing is sold in two-semester blocks. Units may be purchased over time. In Wyoming, tuition and housing are sold by semesters. Both states allow for purchase over time or in a single lump-sum. Other states are establishing sales procedures. Setting the full four years of tuition and fees as the purchase unit is possible under a prepayment plan. In Illinois, the denomination of the savings bonds was expected to be \$5,000.

Qualified Beneficiary

Persons qualified to be beneficiaries vary among the plans. The majority of prepayment plans require the named beneficiary to be a resident of the state, at least at the time of initial purchase. Beneficiaries who are nonresident at the time of matriculation, however, are subject to nonresident tuition rates.

As a consequence, benefits are prorated to the amount of costs covered by prevailing resident tuition rates. Wyoming's plan, in contrast, is explicitly open to nonresidents with provision for prepayment of nonresident tuition. Under the Illinois plan, anyone may be a beneficiary of state savings bonds, though the bonds will be sold only within the state.

Qualified Purchaser

Barring establishment of administrative rules to the contrary, anyone may purchase a prepayment contract or savings bonds for a qualified beneficiary.

Limits on Number of Participants

No specific limits on the number of participants appear in the legislation establishing the various plans. Provisions have been made for establishing such limits through administrative rules. The Michigan plan cites actuarial soundness as criteria for establishing limits. The Illinois plan allows for restrictions on the amount of bonds purchased by an individual family.

Purchase Price

A price schedule has been established for Wyoming's prepaid tuition plan. The price to the purchaser depends upon the year of the beneficiary's initial enrollment. Thus, the price in 1987 for four years of tuition and housing at the University of Wyoming starting in fall 1996 is \$9,965, while the price for the four years starting in fall 2006 is \$4,327.

Purchase prices for other prepaid tuition plans have not been established. Most states are awaiting arrangement of administrative matters, including completion of financial and actuarial studies. Factors that will affect price include anticipated increases in tuition, anticipated return on investments, and time limits on the use of benefits or, in the case of savings bonds, maturity date. Schedules of prices likely would be subject to periodic adjustments to

reflect changing circumstances. Several prepayment plans stipulate that, for contracts initiated less than four years before a beneficiary's anticipated attendance, payment be based on the highest prevailing tuition rates among designated institutions.

In Illinois, the price of savings bonds varies by date of maturity. Based on interest rates in early December 1987, the estimated price of a \$5,000 bond maturing in 20 years is between \$950 and \$1,000. The estimated price of a bond maturing in five years is \$3,500.

Time Limits on Purchase or Use

To date, only Wyoming's plan has time limits. Purchase must occur no more than 17 years and no less than 10 years before the first fall term of attendance. Benefits are available for use no more than six years beyond the first year of attendance. No limitations have been adopted for plans in other states. The matter either is awaiting establishment of administrative rules or has not been addressed.

Portability to Other Institutions

Portability of benefits varies. Illinois savings bonds may be used anywhere, though the extra yield is available only when used at an authorized institution in the state. Coverage in prepayment plans largely is directed toward public institutions within a state. Some plans, however, allow for use of benefits at other institutions. The Maine plan permits use of funds for attendance at any accredited institution as long as the amount does not exceed the cost of resident tuition at a state institution. With similar ceilings, the plans in Florida and Michigan allow use of accumulated benefits at private institutions within the respective states.

Transferability to Other Beneficiaries

Most states with prepayment plans provide for transfer of benefits to other beneficiaries. Details are to be incorporated in administrative rules.

Tax Treatment

Tax treatment might be an important element in the success or failure of state plans to attract participants. Treatment of prepayment plans by the federal government is a major issue awaiting resolution. The state of Michigan has requested a ruling from the Internal Revenue Service (IRS) to grant tax-exempt status for its plan. The state claims that the benefits from its plan constitute a contractual service rather than a return on investment subject to federal income tax. An exemption for either the purchaser or the beneficiary would make participation in the plan financially attractive to many individuals. Lack of a federal tax exemption, conversely, would make the plan less appealing. Florida, Indiana, Maine, Michigan, and Tennessee have stipulated that their prepayment plans will not be implemented until the IRS has ruled.

Savings bonds issued by the state of Illinois already are exempt from federal income tax. They are municipal bonds, earnings from which are not subject to taxation.

Tax treatment at the state level varies. Benefits from prepayment plans are viewed as contractual obligations, not earnings. States with an income tax, therefore, exempt from taxation tuition payments on behalf of a beneficiary made to a public institution covered by the plan. Indiana further exempts from taxation any benefits that are used for payment at private institutions within the state. Michigan allows purchasers to deduct the amount of their payments from earned income before taxes. Illinois grants a tax exemption from the earnings on its savings bonds, something which the state does not grant on the earnings from other in-state municipal bonds.

Termination of Contracts

All prepayment plans provide for termination of contracts by the purchaser or beneficiary. Typically, termination with refund is allowable upon the death of the beneficiary, inability of the beneficiary to gain admission to a public institution covered by the contract, certification of the beneficiary's decision not to attend a state institution, or other reasons that may be determined by the plan's administrators.

Refunds

States with prepayment plans have a variety of refund policies. Indiana, Maine, and Michigan allow purchasers to choose between two options. One is a plan with refunds bearing no interest earnings, hence not subject to taxation. The other is a plan with refunds bearing interest earnings that are subject to taxation. In either case, refunds are not allowed after the beneficiary completes one half of a baccalaureate program. This does not apply to beneficiaries who stop their formal education after completing programs at two-year institutions.

Florida permits refunds of unused payments without interest, and it leaves open the possibility of assessing fees or penalties on refunds. Wyoming allows refund of the entire advanced payment, less adjustments for any benefits used, plus four percent annual interest. Tennessee's refund policy is to be determined.

Administration

The six states with prepayment plans have created a board or committee to supervise operation of the plans. Powers of these bodies include determining operational policies and formulating rules. In most cases, these bodies have authority to make investment decisions. They also are intended to be wholly or largely self-sufficient through fees or investment earnings. Florida and Maine

have bodies with power to contract with private firms for managerial and investment services. The board in Michigan also is independent with broad powers, but the degree of its self-sufficiency is not specified. The boards in Indiana and Tennessee have broad powers and are to be financially self-sustaining. They are, however, to be placed administratively in existing state agencies. In Wyoming, a committee determines rules and prices, but the plan is operated under the University of Wyoming Board of Trustees.

In Illinois, a body was created to provide advice on rules for the program and marketing of bonds. It also is to review the program. The sale of bonds is under the authority of the director of the Bureau of the Budget.

Actuarial, Investment, and Cost Assumptions

The prepayment plans were enacted without prior analysis of actuarial matters, investment returns, and projected educational costs. Assumptions about attrition rates, investment yields, accumulation period, and educational costs are necessary to establish purchase prices and other terms and conditions of prepayment plans.

The Wyoming plan contains assumptions about costs and investment earnings. Projections of covered costs are based on historic trends in various price indices and other factors. Investments are pegged to interest rates on U.S. Treasury bills. Allowance also has been made for administrative costs.

Termination of Program

Two states provide for the termination of plans. Florida may terminate the program when it is deemed financially unfeasible. Michigan's plan may be terminated any time that it is considered actuarially unsound. In a third state, Illinois, the plan effectively ends upon the sale of the authorized amount of savings bonds, unless a new authorization is made.

State Obligations

Several states assume or renounce obligations in conjunction with the savings or prepayment plans.

Florida pledges to appropriate funds to meet certain obligations in case of the program's termination. For beneficiaries who already are attending college or who are within one year of initial enrollment, the state will provide benefits directly. In cases where initial enrollment is more than one year in the future, the state will return all payments with interest at rates currently prevailing in savings accounts.

Illinois exempts up to \$25,000 in the mature value of its savings bonds from consideration as a student financial resource in applications for student financial aid. The state also assumes the administrative costs associated with the sale and redemption of bonds.

Indiana renounces any legal obligation by the state government or the state's public post-secondary institutions to assume responsibility for providing benefits under the prepayment plan.

Maine undertakes no obligation for its prepayment plan except to appropriate \$10,000 for initial administrative costs. The money, however, is to be repaid to the state from the plan's proceeds.

Michigan and Tennessee do not explicitly assume or renounce financial support for the plan or responsibility for meeting the obligations of their plans. Michigan, however, provides for the distribution of the plan's assets among participants if it is terminated.

Wyoming pledges no guarantee for its plan. The state, however, leaves open two possibilities in case the plan is unable to meet its obligations. One is direct state appropriations. The other is a requirement that institutions absorb the deficiency by accepting available funds in the plan as payment for current charges.

PROPOSED PLANS

Several proposed state plans receive attention because of their unusual features. Proposals from four states briefly are reviewed here: Massachusetts, Missouri, New Jersey, and New York.

Massachusetts

At the request of Governor Michael Dukakis, the Massachusetts Board of Regents developed a combined savings and tuition prepayment plan. The savings portion would involve creation of zero-coupon state bonds, earning market rate interest with a one percent bonus upon redemption at any college. The prepayment portion would involve the purchase of tuition certificates whose value would be proportional to tuition rates at the time of purchase. Certificates would be redeemable at public and private institutions in the state. In case of insufficient earnings from investments to meet future tuition rates, the state and institutions would share responsibility to absorb the difference. Bondholders could convert bonds to tuition certificates.

Missouri

Governor John Ashcroft proposed the creation of special investment accounts for families to save for their children's post-secondary education. Individual families could select the financial institution and type of investment for their accounts, much like an Individual Retirement Account. Annual contributions of up to \$2,000 per child until the child's 18th birthday would be deductible from income for state taxes. Earnings would be exempt from state taxes. Proceeds could be used for tuition, fees, room, and board. A bill to establish the plan was introduced in 1987 but was not approved.

New Jersey

A tuition prepayment plan for New Jersey is under study. Tuition certificates sold under the plan would be redeemable at any public institution of higher education in the state and any private institution in the state that elected to participate. Institutions would be guaranteed payment of 90 percent of future tuition. If returns on the plan's investments were enough to match the price of tuition, institutions would receive 100 percent. If returns were not enough, institutions would have to accept as little as 90 percent, thereby absorbing the other 10 percent.

In simulations of the proposed plan, three assumptions are noteworthy.¹⁵ First, attrition rates are set at 30 percent. In other words, for the plan to be actuarially sound under these simulations, almost one third of the named beneficiaries would have to forego their benefits. Second, a set number of new beneficiaries enter the plan each year. This suggests that the number of beneficiaries could be restricted. Third, new beneficiaries enter the plan in a uniform, steady stream between ages 1 and 14. These particular simulations, thus, do not take into account the possibility of entrants being concentrated in a certain age group, such as between 8 and 12.

New York

The State Education Department has developed a proposal for a state-operated savings fund for residents. Annual contributions of up to \$2,000 per child would be deductible from income for state taxes for families with incomes of up to \$85,000. Participating families with low incomes would be eligible for matching contributions from the state. Tax-exempt returns at interest rates at least equal to those on U.S. Savings Bonds would be guaranteed.

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Lutz K. Berkner, Simulating a State Guaranteed Tuition Plan: New Jersey Proposal (New Jersey Department of Higher Education, 1987).

SUMMARY AND CONCLUSION

The value of state plans for savings incentives and prepayment of tuition to prospective participants is not yet measurable. Most plans are in a formative stage. Only one state, Wyoming, has a prepayment plan in operation, and it is based on conservative investment assumptions. Until actuaries and financial experts have conducted analyses, important features of other prepayment plans will remain unclear. Levels of participation and length of accumulation periods must be understood in order to establish sound investment strategies and price structures. Other terms and conditions also must be formulated.

Another unknown is the obligation of state governments under the prepayment plans. All plans are supposed to be financially self-sufficient. Several state governments have indicated their intention to minimize or avoid responsibility for obligations incurred by the entities administering the plans. If the plans were to experience financial difficulties, benefits might have to be withheld unless support from state governments were forthcoming.

CHAPTER V. EXISTING AND PROPOSED PLANS FROM OTHER SOURCES

Dedicated savings and prepaid tuition plans have been established or proposed by entities other than state governments. This chapter reviews plans from post-secondary institutions, the federal government, and private organizations, commercial as well as non-profit. Only plans that are dedicated specifically to post-secondary education are included. Savings instruments that have wider applicability were discussed in Chapter III.

EXISTING PLANS

Tuition prepayment and dedicated savings plans are available from a variety of providers. Some are sponsored by and limited to a single institution. Other plans with fewer restrictions on use are offered by either commercial or non-profit organizations.

Short-term Institutional Prepayment Plans

Some colleges and universities accept prepayment of tuition for entering students. Typically, this involves payment of four-years worth of tuition at the rate in effect when the student matriculates. A variation of this is payment of a premium with the first year's tuition in return for a freeze on tuition and fees in the following years. In either case, the student avoids paying for any subsequent increase in tuition.

At least three institutions in Minnesota offer an option for short-term prepayment. Carleton College and St. Olaf College accept a lump-sum prepayment for four years of tuition at the time of entrance. Gustavus Adolphus College

freezes tuition at freshman year rates upon payment of a \$1,000 premium early in the freshman year.¹⁶

Long-Term Institutional Prepayment Plans

Several institutions in the country offer plans for prepayment of tuition years before a child is old enough to attend. One of the most widely known plans is available at Duquesne University in Pittsburgh. Similar plans are available at other institutions, such as the University of Detroit and Nichols College in Massachusetts.¹⁷ Such plans guarantee tuition for a price that can be a small fraction of tuition costs projected up to 18 years into the future. They may require a lump-sum payment that may be financed over time. They also may be restricted to certain groups, such as alumni. Refunds may be limited to actual payments. Use of benefits at other institutions also may be possible under certain circumstances.

According to a recent analysis, high rates of interest or attrition are necessary for the the Duquesne Plan to balance financially. The prepayment price in 1986 was \$9,182, while the projected tuition for a four-year-old child expected to attend from 2000 to 2004 is \$102,604. If all beneficiaries were to attend, a 14 percent rate of return on the prepayment price would be necessary to cover tuition. With a more realistic 9.5 percent rate of return, accumulated funds would be sufficient for only four out of nine named beneficiaries to be enrolled at projected tuition rates. Enrollment of more beneficiaries would require the institution to absorb additional students without additional revenue.¹⁸

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¹⁶ St. Paul Pioneer Press Dispatch, "In Minnesota, Some Schools Offering Hedge Against Escalating Tuition Costs," (Tuesday, September 15, 1987), p. 48.
¹⁷ Nichols College, "The Nichols College Endowed Alumni Tuition Program," (n.d.); and The University of Detroit, "The University of Detroit Endowed Tuition Program," (n.d.).
¹⁸ Edward B. Fiske, "Investment Accounts Gain Favor as Way to Pay College Costs," The New York Times, 134 (July 12, 1987), pp. 1, 9.

Other Plans

Privately operated plans directed toward the cost of attending a post-secondary institution have become available in recent months. One, offered by the National Tuition Maintenance Organization, a non-profit organization, combines features of a prepayment plan and a savings plan. Banking institutions across the country are offering plans that essentially place widely available savings instruments into a package labeled for educational purposes.¹⁹ The package might include additional services such as provision of information on the cost of attendance. One such plan, discussed below, is the "CollegeSure Account," offered by the College Savings Bank in New Jersey.

National Tuition Maintenance Organization. The National Tuition Maintenance Organization is a non-profit organization located in Plymouth, Michigan.²⁰ Funds placed on account with the organization can be used as savings, tuition prepayment, or both. Choice of use is not necessary until attendance begins. The prepayment option, however, applies only at institutions that are members of the plan.

- o **Tuition prepayment**--If a beneficiary attends an institution that is a member of the plan, the institution agrees to accept principal plus earned interest in the beneficiary's account as payment for current tuition and required fees. The amount of coverage is proportional to the amount of principal contributed to the plan and the institution's tuition rate at the time of the contribution. For example, \$5,000 may be contributed to a beneficiary's account in 1987. If in 2001 the beneficiary attends a member institution where tuition was \$5,000 per year in 1987, the beneficiary would be entitled to one year's tuition from the principal and interest on the 1987 contribution. If tuition had been \$10,000, the benefit would be one-half year's tuition.

Benefits continue until funds in the account are exhausted. Then, the beneficiary must pay current tuition charges. If a surplus in the account exists, the beneficiary may use the funds for other educational expenses. This includes study beyond the bachelor's degree until the account's expiration date.

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Consumer Bankers Association, "Student Lending: CBA Update" (October 4, 1987).

²⁰ Materials furnished by the National Tuition Maintenance Organization of Plymouth, Michigan.

- o **Savings**--If a beneficiary attends an institution that is not a member of the plan, the accumulated payments and interest may be used to cover any educational expense until the account's expiration date. Interest earnings are guaranteed at a rate established when a contribution is made.

Payments into the plan are invested in U.S. government securities scheduled for maturity during the year that the beneficiary reaches age 18. The beneficiary must use the benefits within six years of reaching age 18 or graduation from high school, whichever comes first. Extensions of up to five years are permitted for military and other service. Benefits may be applied to all expenses related to education for which payment may be made directly from the plan to the institution. Benefits are portable among institutions, but they are not transferable to other beneficiaries. Tax status of the benefits would depend upon tax laws when benefits are claimed. Termination is allowed only upon death of the beneficiary, at which time only the amount of the actual prepayments is refundable.

Member institutions themselves may market and sell subscriptions to the plan. They are allowed to keep one tenth of one percent of the prepayments made into their accounts, and they are allowed to keep all earnings from attrition in their accounts. Institutions also have the right not to admit beneficiaries if too many beneficiaries apply and if earnings from the plan are insufficient to cover expenses.

The National Tuition Maintenance Organization markets and sells subscriptions to the plan, purchases government securities for investment, administers accounts, and pays benefits. The organization also provides two free counseling sessions for each beneficiary. Financial support for operations comes from a portion of the interest earnings from investments. Funds from attrition and from surpluses left in accounts at the time of expiration remain with the organization.

"CollegeSure Account". The "CollegeSure Account," offered by the College Savings Bank of Princeton, New Jersey, is a savings plan. It involves the purchase of certificates of deposit with variable interest rates set somewhat below the annual increase in the College Board's Independent College 500 Index.²¹ Purchase of certificates may occur over time with maturity dates set to coincide with the years in which a child is expected to attend college. Deposits must be in minimum increments of \$1,000. Actual amounts invested in certificates would depend on the purchaser's resources and the anticipated costs of a child's education. The bank provides periodic information on how accounts are keeping pace with college costs.

The certificates of deposit are ordinary banking instruments adapted for meeting the cost of attending college. They belong to the purchasers, who may use the proceeds for any purpose. Income from the certificates also is taxable under prevailing tax laws, and penalties are assessed for early withdrawal. The bank is a member of the Federal Deposit Insurance Corporation.

In an example of how the plan might work, the bank starts with a hypothetical child five years old and a hypothetical college where tuition, fees, room, and board in 1987 are \$11,312. The projected cost for four years of college from 2000 to 2003 is \$181,241. To reach this amount, the bank estimates that a single deposit of just under \$60,000 will earn almost \$121,300 by 2003. Alternatively, a purchaser could make an initial deposit of \$10,000 with additional deposits of \$1,512 every three months for the next 13 years, or an initial deposit of \$2,500 with quarterly deposits of \$1,739 for the next 13 years.²²

Two items are noteworthy. First, the single, lump-sum payment, presumably the option with the smallest outlay from the purchaser, exceeds the current cost

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This is a measure of the cost of tuition, fees, room, and board prepared annually from data collected by the College Board in its Annual Survey of Colleges.

²² Materials furnished by the College Savings Bank, Princeton, New Jersey.

of attendance. The plan, far from providing an effective discount from current costs, assumes that higher outlays will be necessary. Second, income taxes likely would run into the tens of thousands of dollars over the term of the plan, depending on family income and state of residence. Funds to pay the taxes would have to come from a source other than earnings from the account.

PROPOSED PLANS

The following section summarizes some of the plans that have been proposed within the past year.

Federal Proposals

Following the emergence of state plans, activity began at the federal level. Initially, proposals focused on providing favorable tax treatment of benefits from state plans. By the summer of 1987, a flurry of proposals for federal plans had been introduced in Congress or presented to the public.

Measures to establish national education trust funds operated by the federal government were introduced in the House of Representatives, H.R. 2509, and the Senate, S. 1572. They would allow families to make tax-deductible contributions up to \$2,000 annually to the fund for up to 24 years. Deductibility would diminish and ultimately disappear when family income exceeds \$100,000. Contributions would be invested in U.S. government securities. The House author is Representative Pat Williams of Montana, chair of the Subcommittee on Postsecondary Education. The Senate author is Claiborne Pell of Rhode Island.

Other measures would authorize education savings accounts with favorable tax treatment. Senator Robert Dole of Kansas and several colleagues, including Senator David Durenburger of Minnesota, have introduced several alternative measures along those lines, S. 1659, S. 1660, and S. 1661. Various proposals have appeared in the House.

Creation of federal education savings bonds also is under consideration. A group led by Senator Dole has introduced a measure to create such bonds, S. 1662. Vice President George Bush also has advocated the concept.

Senators Edward Kennedy of Massachusetts and Pell have proposed the use of Series EE U.S. Savings Bonds to finance an individual's post-secondary education. Under the proposal, interest earned would not be subject to federal income tax if the bonds were redeemed to pay tuition. The tax advantage would be limited to families with annual income below a specified level.

Private Proposals--Blandin Foundation

The Blandin Foundation of Grand Rapids, Minnesota, is working with the Citizens' Scholarship Foundation of America of St. Peter, Minnesota, to explore the legal and financial feasibility of establishing a savings plan. The intent is to encourage parents in Minnesota to begin regular savings for their children's post-secondary education when the children are young. The plan is awaiting responses by the IRS regarding tax treatment of some features under consideration.

As envisioned, parents would make systematic contributions, perhaps through payroll deductions, to an account in a child's name. A goal for accumulated funds would be set to reflect a family's educational preferences and financial circumstances. Eligibility for participation in the plan might be limited to families with incomes below a specified level.

Use of proceeds would be limited to payment of tuition and fees. Access to funds would end at a specified time, perhaps when the beneficiary reached age 25. Principal and interest would be refundable in case of a beneficiary's death or a family emergency. Transfer of accounts to another beneficiary would be permitted.

Parents might have the option to invest contributions in a variety of financial instruments. The plan envisions contributions from corporations and others to provide matching funds to enhance the earnings of the individual accounts. These contributions would be structured as charitable contributions to make them deductible from federal income taxes. Any unused matching funds upon the expiration of a beneficiary's eligibility would revert to a general fund for distribution to other accounts.

SUMMARY AND CONCLUSION

Examination of prepayment plans offered by private entities provides insights into financial factors not always evident in discussion of state plans. Plans that offer a considerable discount from current tuition prices anticipate one or both of the following developments. One is a high, by some estimates unrealistically high, return on investment. The other is a high rate of attrition generating sufficient funds to meet obligations to those beneficiaries who ultimately do attend. In the absence of a high return on investment, substantial earnings from attrition, or a guarantee of a direct government subsidy, the purchase price of a prepayment contract likely would be substantial. In that event, a tax benefit might be one of the few incentives, if not the only one, to make plans financially attractive.

Uncertainty exists over the role of the federal government. Several proposals to establish federal plans or to provide favorable tax treatment for state plans have been made. The topic could become an issue during the 1988 presidential campaign. A federal program likely would involve a tax expenditure, which is the foregoing of tax revenue through a tax exemption for a specific purpose. Concern over federal budget deficits and reluctance to modify recently enacted tax laws raise questions about the likelihood of federal action. Political pressure, however, could lead to enactment of a federal plan

if the popularity of the concept grows. Establishment of a federal plan, however, would raise questions about the status and effectiveness of state plans.

Meanwhile, the finance industry has responded to concerns about planning for a post-secondary education. Increasingly, attention has focused on how to use existing financial instruments to accumulate funds to cover the cost of attendance. Financial institutions and other private organizations have begun to market plans in a package designed specifically for that purpose.

CHAPTER VI. IMPACT ON PARTICIPANTS

The distribution of benefits and risks among affected parties has a major bearing on the attractiveness of saving incentive and prepaid tuition plans. The ensuing three chapters answer two questions: What are the benefits and who would receive them? What are the costs and risks and who would bear them? To a considerable extent, answers depend on specific circumstances in Minnesota. Lack of experience and empirical data pertaining to savings and prepayment plans for post-secondary education contribute to the tentative nature of the analysis. While discussion proceeds along topical lines, direct comparisons of savings plans and prepaid tuition plans appear in the concluding sections of each of the three chapters.

This chapter focuses on the possible impact on families and beneficiaries who might participate in plans. The two subsequent chapters address possible impacts on post-secondary institutions and state government.

Discussion of how saving incentive and prepaid tuition plans could affect participants is organized into three segments. The first reviews benefits available under various state plans. The second examines direct costs. The third examines risks.

BENEFITS

Benefits available to participants in existing and proposed plans have been presented in Chapter IV. The following material provides further discussion.

Cash

Holders of savings accounts and bonds receive direct benefits in the form of accumulated funds that can be applied toward the cost of attending a post-secondary institution. Bonuses for attending an in-state institution, as

featured in the Illinois College Savings Bond program, would constitute another benefit. The terms of a plan may or may not carry restrictions on the use of proceeds, such as limitation to use at in-state institutions or to use for undergraduate education.

Services

Direct benefits to participants in prepayment plans are specified units of instruction, housing, or both. These services are to be used without additional payment by a named beneficiary upon attendance at a post-secondary institution. Typically, only residents of the state operating the plan who attend an institution within the state are entitled to full benefits. Coverage in all prepayment plans enacted or proposed to date is limited to undergraduate instruction.

Investment

A state plan could provide a significant return on investment. Tuition could increase at a rate higher than prevailing interest rates. In that case, the value of the prepaid tuition benefit would increase more than the value of other investments. The increased value of the benefit, moreover, would be tax free, at least at the state level.

Favorable Tax Treatment

Favorable tax treatment could be a benefit provided under a plan in states like Minnesota that have a personal income tax. The value of the benefit would depend on factors such as tax rates and the nature of the tax break.

Special Benefit. A plan would be valuable to the extent that it would provide an additional tax benefit to participants. Such a benefit could be in the form of a deduction or a credit on state income taxes for savers or for purchasers of prepaid tuition. Illinois is offering a special benefit in the form of an exemption from taxes of earnings on state bonds. Residents of

Illinois otherwise pay taxes for earnings on most Illinois municipal bonds. Minnesota could not provide this as an additional benefit because the state already exempts from taxation all earnings from Minnesota municipal bonds held by state residents.

Federal Tax Treatment. Attractiveness of state plans might depend more on federal tax treatment than on state treatment. Federal tax breaks likely would have a much greater impact because federal tax rates are considerably higher than state taxes.

Nature of Benefit. Virtually all discussion of favorable tax treatment related to state plans focuses on outright tax exemptions or tax credits for individual contributions and earnings. This is distinct from tax deferments provided in financial instruments such as IRAs and annuities. Holders of those ultimately pay taxes on contributions and earnings upon withdrawal or redemption of funds. Individuals presumably are retired and are in lower tax brackets than they were when contributions were made and interest was earned. Their deferred income, thus, is subject to lower taxes.

In contrast, a tax deferment for a college financing plan could result in higher taxes for parents. Most children reach college age when parents are at the peak of their earning power and, thus, in a high tax bracket. Withdrawing funds at that time would subject them to high taxes. Allowing accounts to be placed in a child's name, however, could reduce taxes because the child is likely to be in a low tax bracket.

Distribution. With a progressive income tax, favorable tax treatment could have greater value to families with high incomes, if contributions and earnings were deductible from taxable income. In effect, the plan would be a tax shelter. If a credit against taxes due were established instead, all families participating in the plan would have the same benefit, assuming they pay taxes.

If a state plan in Minnesota provided favorable income tax treatment, the benefits likely would flow more to families with middle and high incomes rather than to families with low incomes. In Minnesota, income tax rates scheduled to go into effect in 1988 are 8 percent and 6 percent. The higher rate applies to the following categories of taxpayers: married couples filing jointly with incomes over \$19,000, heads of households with incomes over \$16,000, and individuals with incomes over \$13,000.

The amounts of money involved are not large. A deduction from income of \$2,000 for a deposit into a savings account would be worth \$160 and \$120 per year respectively to individuals above and below the cut-off. Interest earned over the years would be taxed at similar rates. To obtain \$160 annual tax benefit on interest earnings, however, the account holder in the 8 percent bracket would have to earn \$2,000 per year. Reaching this would take several years. For example, placing \$2,000 at the beginning of every year into an account bearing seven percent interest compounded annually would require 11 years for annual interest to exceed \$2,000.

Experience With Tax Benefits. Recent experience suggests that participation in a state savings plan might be low for three reasons. First, individuals might find their own solutions to financing problems. Second, anxiety that arouses interest in a plan might diminish as circumstances change. Third, state tax incentives alone might not be a strong enough incentive for participation. The contrast between state housing accounts in Minnesota and Individual Retirement Accounts illustrates this.

In 1980, Minnesota enacted the Young Family Housing Act, which authorized the establishment of individual housing accounts. This was a period of rising real estate values and high interest rates that stimulated widespread concern

about the ability of young families to afford a house. The state responded with a saving incentive plan to encourage and help Minnesota families purchase their first homes.

Under the plan, families that had not owned a home could deposit up to \$2,500 per year in a housing account to a maximum of \$10,000 in total deposits. The first \$1,500 deposited each year was deductible from income for state tax purposes. Interest earnings were exempt from taxes.

Only 45 Minnesotans actually opened housing accounts, according to staff of the State Department of Revenue. Further, only a few financial institutions offered the accounts. Explanations for this are speculative, but they include:

- o availability of financing through more conventional sources;
- o too many restrictions on the use of accounts;
- o insufficient incentives in the absence of federal tax breaks to match favorable tax treatment at the state level; and
- o cumbersome and expensive reporting requirements that resulted in financial institutions not promoting or publicizing the accounts.

Ultimately, the cost of housing receded as an issue when real estate values stabilized and interest rates declined.

The experience with Individual Retirement Accounts illustrates the power of federal over state tax incentives. For several years during the early 1980s, contributions to IRAs did not receive favorable tax treatment in Minnesota. Nonetheless, many state residents opened accounts to obtain the federal tax advantages. Minnesota eventually treated IRAs the same as the federal government.

Encouragement of Attendance

Participation in a plan might improve chances for participation in and successful completion of post-secondary education. Many individuals are uncertain about their plans after high school. Sometimes this uncertainty

results from concern over the ability to pay the cost of attending a post-secondary institution. Among high school juniors in Minnesota recently, financial reasons frequently were cited for plans not to pursue post-secondary education immediately after graduation.²³

Resources accumulated in a plan, even if they met only part of the cost, could provide enough financial security for an individual to start a post-secondary education. The availability of funds from a plan could reduce the need for income to pay the cost of attendance. The individual then might be able to devote more time to studies and less time working to earn money. As a result, academic performance could improve and completion of programs could occur in less time.

DIRECT COSTS

Obtaining full benefit from a savings or a tuition prepayment plan requires commitment of substantial amounts of money. Accumulating sufficient funds to cover the cost through savings requires not only an early start, but also sizable deposits. The proposed savings plan in Missouri, for example, would allow deposits of up to \$2,000 per year. While annual deposits could be less than that, smaller deposits would result in a smaller accumulation of funds.

In prepayment plans, four years of tuition, even at a public institution, is likely to cost several thousand dollars purchased when a child is young. Wyoming, for example, charges nearly \$10,000 for four years of tuition and housing at the University of Wyoming starting in fall 1996. A child eligible for that would now be about 9 or 10 years old. The prepurchase price for a new born starting in fall 2006 is about \$4,300. These prices reflect certain assumptions and risks by the state.

²³-----
Minnesota Higher Education Coordinating Board, Summary of Responses to the Plans and Background Survey and Aptitude Test Score Trends for Minnesota High School Juniors 1978-1987 (St. Paul, 1987), pp. 11-12.

Wyoming and other states allow for purchase of tuition in units over time that add to coverage for a bachelor's degree. The outlay for one unit would be substantially less than for the entire degree program. Over time, however, the price per unit likely would rise, resulting in greater outlays for coverage purchased in installments rather than in a lump sum.

RISKS

Risks as well as costs to participants could be substantial. Some risks emanate from restrictions, penalties, and other provisions of a plan. Restrictions could be placed on where, when, and for whom benefits may be used. Penalties could involve the forfeiture of contributions or interest earnings. Other terms could allow for the termination of a plan without receipt of benefits. Additional risks pertain to relative return on investment. Further discussion of various risks appears below.

Restricted Use of Funds

Funds in many savings plans and virtually all prepaid tuition plans would be dedicated solely to the cost of attendance. Participants in the plans would not be able to gain access to their funds and use them for other purposes. Changes in family priorities or circumstances, however, might make other uses of funds more advantageous. A family might want money to buy a house, to start a business, or to pursue a lucrative investment. A family might decide that the cost of a post-secondary education will be assumed by the person attending out of current income. Catastrophic illness might occur, consuming much of a family's resources. Some savings plans might allow access to funds in cases of emergency, though a financial penalty might be imposed.

Ownership of funds also is an issue, especially in a savings plan in the name of a beneficiary. Receipt of full tax benefits might depend on the effective transfer of funds from parents or other benefactors to the beneficiary. If

transfer were to occur, the new beneficiary would gain control of the money. If transfer were not to occur, the benefactor might be taxed when funds were withdrawn.

Nonattendance

A named beneficiary might not attend a post-secondary institution because of death, disability, decision not to pursue further education, decision to attend an undesignated institution, or denial of admission. Any of these might occur years after a family had invested its money in a dedicated savings plan or a prepaid tuition plan. Some prepaid tuition plans, perhaps most, not only would assume attrition but also would base prices and expected financial solvency on it. A plan proposed in New Jersey, for example, assumes an attrition rate of 30 percent.

Most, if not all, existing and proposed prepaid tuition plans allow for refunds in case of nonattendance. Sometimes the amount refunded is limited to contributions to the plan. In that case, the contributor loses the increased value from the benefit or the potential interest earnings that the contribution could have produced if invested elsewhere. Other plans allow for refunds with interest. The earnings, however, might be lower than the yields from other investments. Further, interest earnings included in a refund almost certainly would be considered taxable income.

Most plans also permit transfer of benefits if the original beneficiary is unable to use them. This would enable families participating in state prepayment plans to maintain returns on their investments, though transfer would not be limited to family members. Transfer of benefits through sale to another party usually is prohibited.

Uncovered Costs

Participants in a savings or a prepayment plan could find a sizable portion of the cost of attendance not covered. Prepayment plans limited to tuition would leave students and their families with the responsibility of paying for living expenses and other items. These amount to more than half the cost of attending a public institution. Savings plans that have limits on annual contributions might not accumulate funds to cover the total cost of attending college for four years, especially at a private institution.

Advanced Study

Costs of graduate and professional education likely would not be covered. Advanced study frequently involves much higher costs of attendance than undergraduate study. Most plans, however, are targeted toward, if not restricted to, undergraduate education. Even if residual funds in a beneficiary's account could be used for advanced study, the amount available likely would not be significant.

Loss of Eligibility

Under most enacted or proposed state plans, a named beneficiary could lose eligibility for benefits by moving to another state. Geographic mobility, however, has been a characteristic of society as individuals accept transfer in employment or seek new career opportunities. Typically, a named beneficiary in a state plan must be a legal resident of the state, at least initially. According to various plans, moving outside the state could have several consequences. Eligibility for in-state tuition could be terminated. In some prepaid tuition plans, a beneficiary still would be able to attend designated institutions, but the benefit would be limited to a reduction in nonresident tuition equal to the current value of resident tuition. Beyond this, tax benefits likely would not apply in the new state of residence.

Minnesota has had rates of in-migration and out-migration among the lowest in the country.²⁴ Whether or not migration patterns of affluent families with college-bound children are similar to the overall pattern is not clear.

Restricted or Inappropriate Educational Choice

In state plans for prepaid tuition, full benefits are restricted to public institutions. Tuition rates at public institutions, however, vary so that benefits have a higher monetary value at some institutions than at others. Typically, benefits apply to private institutions but only in an amount equal to current tuition prices at the state's public universities. Further, use of benefits usually is restricted to institutions within the state, though Maine's plan permits use of benefits elsewhere. Savings plans might be more flexible than prepayment plans in the use of benefits.

Many individuals are not certain about their education plans until, or after, completion of high school. In Minnesota recently, fewer than 30 percent of high school juniors who expressed interest in attending a post-secondary institution in Minnesota actually attended their first choice of institution immediately following graduation, as shown in Table 2. While postponement of plans could account for much of this, change in plans is common. As seen in Table 3, substantial numbers of individuals had different pursuits from what they had indicated as their first choice when high school juniors. On balance, students tended to shift to community colleges from other systems. At the same time, students tended to shift from the University of Minnesota to other systems.

Restrictions incorporated in savings or prepaid tuition plans could impose or induce inappropriate educational choices. Named beneficiaries might feel

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Minnesota State Planning Agency, Office of State Demographer, "Minnesotans Move Frequently, But Few People Enter or Leave State," Population Notes, (February 1984).

TABLE 2. PERCENT OF SELECTED MINNESOTA HIGH SCHOOL JUNIORS IN 1983-84 ATTENDING FIRST CHOICE OF MINNESOTA POST-SECONDARY INSTITUTION IN FALL 1985¹

<u>System</u>	<u>First Choice as High School Juniors in 1983-84</u>	<u>Number at First Choice in Fall 1985</u>	<u>Percent Attending First Choice</u>
Private 4-Year Colleges	4,790	1,788	37.3%
State University System	5,088	1,798	35.3%
University of Minnesota	7,234	2,149	29.9%
Community College System	3,100	870	28.1%
Technical Institutes	8,769	2,019	23.0%
Private 2-Year Colleges	301	15	5.0%
Minnesota Subtotal	29,282	8,639	29.5%
Other ²	12,777	---	---
TOTAL	42,509	---	---

SOURCE: Minnesota Higher Education Coordinating Board, Post-High School Planning Program, Minnesota's High School Juniors 1983-84: A Summary of Test Scores and Responses to Student Plans and Background Survey (July 1984); Minnesota Higher Education Coordinating Board, Post-High School Planning Program, 1985 Minnesota AVTI Profiles: Albert Lea AVTI (1987); Minnesota Higher Education Coordinating Board, Post-High School Planning Program, 1985 Minnesota Freshmen Profiles: Minnesota Community Colleges (1987); Minnesota Higher Education Coordinating Board, Post-High School Planning Program, 1985 Minnesota Freshmen Profiles: Minnesota Private Colleges (1987); Minnesota Higher Education Coordinating Board, Post-High School Planning Program, 1985 Minnesota Freshmen Profiles: Minnesota Private Junior Colleges (1987); Minnesota Higher Education Coordinating Board, Post-High School Planning Program, 1985 Minnesota Freshmen Profiles: State University System (1987); Minnesota Higher Education Coordinating Board, Post-High School Planning Program, 1985 Minnesota Freshmen Profiles: University of Minnesota (1987).

¹ Limited to participants in Minnesota Post-High School Planning Program.

² Includes other post-secondary institutions in Minnesota, colleges outside Minnesota, no response, and do not know.

TABLE 3. PLANNED POST-HIGH SCHOOL ACTIVITIES AMONG SELECTED MINNESOTA HIGH SCHOOL JUNIORS IN 1983-84
AND ACTUAL ACTIVITIES OF SAME INDIVIDUALS IN FALL 1985¹

	Technical Institutes	Community College System	State University System	U of M	MN Private 4-Year	MN Private 2-Year	Other Minnesota Institutions	College Outside MN	No Response or Do Not Know	Total
Plans 1983-84	8,769	3,100	5,088	7,234	4,790	301	2,098	5,355	5,324	42,059
Actual Fall 1985										
Technical Institutes	2,019	261	239	180	83	20	184	110	345	3,441
Community College	493	870	509	715	335	20	192	315	298	3,747
State University	352	226	1,798	713	458	22	152	463	225	4,409
U of M	139	108	379	2,149	483	14	81	558	192	4,103
MN Private 4-Year	59	70	293	585	1,788	27	71	472	132	3,497
MN Private 2-Year	1	2	13	12	14	15	5	5	5	72
Other ²	5,706	1,563	1,857	2,880	1,629	183	1,413	3,432	4,127	22,790

SOURCE: Minnesota Higher Education Coordinating Board, Post-High School Planning Program, Minnesota's High School Juniors 1983-84: A Summary of Test Scores and Responses to Student Plans and Background Survey (July 1984); Minnesota Higher Education Coordinating Board, Post-High School Planning Program, 1985 Minnesota AVTI Profiles: Albert Lea AVTI (1987); Minnesota Higher Education Coordinating Board, Post-High School Planning Program, 1985 Minnesota Freshmen Profiles: Minnesota Community Colleges (1987); Minnesota Higher Education Coordinating Board, Post-High School Planning Program, 1985 Minnesota Freshmen Profiles: Minnesota Private Colleges (1987); Minnesota Higher Education Coordinating Board, Post-High School Planning Program, 1985 Minnesota Freshmen Profiles: Minnesota Private Junior Colleges (1987); Minnesota Higher Education Coordinating Board, Post-High School Planning Program, 1985 Minnesota Freshmen Profiles: State University System (1987); Minnesota Higher Education Coordinating Board, Post-High School Planning Program, 1985 Minnesota Freshmen Profiles: University of Minnesota (1987).

¹ Juniors participating in Post-High School Planning Program's Plans and Background Survey.

² Includes other Minnesota institutions, colleges outside Minnesota, no responses, and do not know.

obligated to attend institutions where the most benefits might be redeemable, not where instruction might be most suitable. A participant in a prepaid tuition plan, for example, might forego an opportunity to attend a private institution in order to protect the financial investment in the plan. The dilemma would be heightened if a desired program of study were not available at a designated institution in the plan. Even if a program were available at a designated institution, it might not be as suitable as a program elsewhere.

More subtle influences on choice could develop, particularly in prepaid tuition plans with benefits redeemable at several institutions. If tuition rates differed, named beneficiaries might attend higher priced institutions in order to receive a greater monetary value for the funds invested in the plan. The institution, however, might not be suitable for individuals' interests or abilities.

Noncompletion within Time Limits

Terms and conditions of plans regarding noncompletion of programs and time limits on benefits may vary. This is a form of attrition that some plan administrators might factor into price and benefit schedules. A plan could require redemption of benefits within a specified time to avoid forfeiture of funds or other penalties. Examples of this might be loss of eligibility for not beginning attendance by age 24, unconditional loss of eligibility by age 30, or a five-year limit on eligibility following matriculation. Extensions, however, could be provided for military or other service. A plan also could deny refunds to participants if the named beneficiary were to cease attendance after completing half of a four-year program. Exceptions could be made for persons earning a two-year degree or certificate.

Noncompletion of a program within a stipulated period can occur for a variety of reasons. Some individuals experience difficulty in selecting or

persisting in a program of study. Others attend part time because of family commitments, a desire to travel, or an employment opportunity. Still others leave because of academic difficulties or loss of interest. In any case, individuals whose ages are beyond the specified limit might be upset over their exclusion from the plan.

Uneven Costs and Subsidies among Participants

Actual costs of benefits and returns on investment could diverge from anticipated costs and returns to the state in a prepaid tuition plan. That could result in added costs for some participants and reduced costs for others. Higher than anticipated costs or lower than anticipated returns on investments would result in a financial deficiency for the plan. One way to make up the deficiency would be through increased revenue in the form of price increases for new participants. The Michigan plan provides for this contingency. In effect, new participants would pay a surcharge in order to provide benefits to earlier participants. Conversely, lower costs and higher returns on investments could yield a surplus in the plan, which could be passed along to later participants in the form of lower prices. The contributions of earlier participants, thus, would provide a subsidy for new participants.

Termination or Revision of Plan

Loss of promised benefits could occur in the event of a plan's reduction or termination. All existing and proposed state plans are designed for long-term investment by participants, roughly 5 to 18 years. Stability of government policies and programs for that length of time is problematic. Changing priorities often lead to revision, even in popular programs. In Minnesota, for example, the state's tax treatment of Individual Retirement Accounts has undergone several major changes in recent years.

The impact of termination likely would be less severe with savings plans than with prepaid tuition plans. Under a savings plan, the benefit at risk most likely would be an exemption from state taxes. Interest earnings, a major benefit from saving, would remain intact. Moreover, because elimination of a tax exemption would not be retroactive, tax benefits already earned would not be lost.

Under a prepayment plan, the principal benefit, tuition payments, could be at risk through financial insolvency. The state's obligation to provide benefits in the event of insolvency is not clear. No state has yet pledged its full faith and credit to guarantee benefits. All state plans are supposed to be financially self-sufficient, and most are to be operated under the authority of an autonomous body. Wyoming in effect guarantees benefits in two ways: first, through a conservative pricing and investment strategy and, second, through the possibility of post-secondary institutions absorbing financial deficiencies. In contrast, Indiana explicitly absolves the state and its public institutions of post-secondary education from responsibility to provide benefits under the prepaid tuition plan. Florida also absolves itself from such responsibility, except to individuals who have begun or are about to begin post-secondary education. Florida would guarantee refunds of contributions with interest, but interest would be at relatively low short-term rates. Long-term participants, thus, would lose the interest that could have been earned through higher-yield, long-term investments over the same period. Michigan provides for distribution of the plan's assets among participants in case of termination.

Low Return on Investment

Returns from a prepaid tuition plan could be lower than returns from other investments. This would occur if tuition rose at a lower rate than prevailing interest rates. Conversely, returns from a restricted savings plan might be

lower than the increase in tuition. Further, money invested elsewhere might yield a higher effective rate of return than money invested in either a saving incentive or a prepaid tuition plan.

Loss of Financial Aid

Some families participating in a savings plan or a prepaid tuition plan could lose eligibility for need-based student financial aid under current rules. The hypothetical case of two families with similar incomes and other financial circumstances illustrates this point. The first family has been frugal, saving or investing for the children's education. Its accumulated savings or pre-purchased tuition, however, are counted as a financial asset that enhances the parents' ability to help pay the cost of attendance. As a consequence, the amount of student financial aid is reduced or eliminated. The second family has not saved or prepurchased tuition and, thus, does not have an asset to reduce the amount of student financial aid received.

The chances of this actually happening, however, seem to be small for at least two reasons. First, assets are much less important than annual income in determining qualifications for financial aid. Lower awards are likely to result more from level of income than from the amount of assets. Second, a family with income low enough to qualify for student financial aid is not likely to have the money to save or prepurchase tuition in amounts that would reduce awards.

In its savings bond plan, Illinois has addressed this concern over disqualification. The state has exempted the first \$25,000 in redeemed bonds from consideration as assets in state financial aid programs.

SUMMARY AND CONCLUSION

Most saving incentive and prepaid tuition plans are programs for affluent families willing to help pay for the cost of a child's post-secondary education. They are not financial aid programs for low-income families or families with

children at or near college age. Families most likely to take full advantage of any plan are those with young children and significant amounts of disposable income or savings. Grandparents and other relatives could help parents by providing funds for a child. When money is not immediately available, borrowing would be an option for the prepurchase of tuition. If families could obtain loans for this purpose, however, the cost of interest would offset at least some of the benefits of prepayment.

Early participation, many years before a child reaches college age, yields the greatest advantage from a plan. In saving plans, a long duration allows for greater accumulation of principal, earned interest, or both. In guaranteed benefit plans, early participation allows for a deeper discount in the purchase price as the provider assumes responsibility for investing the proceeds. Prepurchase prices generally rise as the time for delivery of the benefit approaches. Moreover, additional costs might be incurred under some plans if initial participation occurred within a few years of post-secondary attendance.

Participation in a plan, however, might not lead to coverage of the entire cost of attendance. A prepaid tuition plan might not cover room and board and other significant expenses. A savings plan might not accumulate enough assets to meet all expenses, especially if the choice of institution changed.

Families must be willing to take several other risks. Foremost among these is that a child might be unwilling or unable to pursue a post-secondary education. Another is that designated institutions might be unsuitable for a child's educational preferences and goals. Other major risks are relocation to another state before a child becomes eligible for benefits, poor financial return on money invested in a plan, and termination of the plan without full benefits.

The nature of benefits, direct costs, and risks for participants would vary by type of plan. Table 4 compares them under three types of plans. The first is a generic prepaid tuition plan incorporating features from various state

TABLE 4. COMPARISON OF PLANS FOR THEIR POSSIBLE IMPACT ON PARTICIPANTS

	<u>Prepaid Tuition (Composite)</u>	<u>Savings Account (IRA Type) Missouri Model</u>	<u>Savings Bonds (Illinois Type)</u>
<u>Benefits</u>			
Nature	Future tuition; perhaps housing.	Cash for educational costs; return dependent on investment instrument.	Cash; fixed rate return.
Tax Advantages	New state income tax exemption on increased value of investment; possible exemption for contribution; federal tax exemption in question.	New state income tax deferment or exemption on contribution or interest earnings or both.	Interest earnings on municipal bonds already tax-exempt at federal level and in Minnesota.
Institutions	Full benefits limited to in-state public institutions; limited benefits at in-state private institutions.	Full benefits at in-state public or private institutions; possible taxation on use of funds out of state.	No restriction; perhaps bonus for in-state attendance.
Level of Education	Undergraduate.	Open.	No restriction, except for seminaries.
<u>Costs</u>			
Contributions	Based on projected costs, investment returns, and actuarial assumptions.	Maximum annual limit, e.g. \$2,000; perhaps income limits for participants.	Based on maturity date and interest rates.
Administrative	Taken from contributions and returns.	Borne by state and financial institutions.	Borne by state.
<u>Risks</u>			
Return on Investment	Return on other investments might exceed tuition increases.	Returns on other investments and inflation might exceed return on savings account.	Returns on other investments and inflation might exceed return on bonds.
Non-Attendance	Refund less than value of benefits.	Availability of all assets, subject to taxation.	No penalty.
Transfer of Benefits	Permitted.	To be determined.	Permitted.
Loss of State Residency	Diminution of benefits.	To be determined.	No penalty.
Refunds	Either principal only or principal with interest subject to taxation.	Withdrawal with penalties.	Redemption at maturity only; perhaps secondary sale permitted.
Termination/Default	With state guarantee, full benefits; without guarantee, refund less than value of benefits.	No loss of benefits earned to date.	Remote.
Inappropriate Educational Choice	Increased risk based on limited choice of institutions and differential in value of tuition coverage.	Wider choice of public and private institutions within state; perhaps extended outside state too.	Virtually unlimited choice.

SOURCE: Minnesota Higher Education Coordinating Board.

plans. The second is a savings account plan patterned after the one proposed in Missouri. The third is a savings bond program such as the one established in Illinois. Differences, especially concerning risk, often are quite distinct.

CHAPTER VII. IMPACT ON POST-SECONDARY INSTITUTIONS

Minnesota's post-secondary institutions would have rather passive roles in state plans for savings or prepaid tuition. The impact on institutions largely would depend on the decisions of others. The state in structuring the plan would designate institutions where benefits could be used: in-state or out-of-state, public or private, four-year or two-year, collegiate or vocational. The state also could impose obligations on designated institutions. Students and their families, through their choice of institutions, would determine where the benefits actually would be spent. This chapter discusses the benefits, direct costs, and risks that a state plan might present to post-secondary institutions.

BENEFITS

Enrollment and the resulting revenue would be the primary benefits that a state plan might bring to a designated institution. Receipt of benefits would depend on the extent to which the plan induces enrollment of students who would not otherwise attend the institution. These students would generate tuition revenue and, at public institutions, state appropriations based on enrollments. This assumes no change in state funding policies resulting in lower appropriations for students participating in a plan.

Reduction in demand for institution-based student financial aid might be another benefit to institutions. This could occur if students requested less aid or were judged less qualified for assistance because of resources accumulated for them in a state plan. Institutions could use the funds to help other students or to support other functions. If this occurred, however, it would heighten the perceived risk that participation in a plan might disqualify students for financial aid.

DIRECT COSTS

Direct costs to institutions likely would be limited to administrative tasks associated with verifying the eligibility of students to receive benefits.

RISKS

Risks to institutions could be significant. The extent of the risks would depend on the nature and features of a state plan. Three possible risks are discussed below. Some risks associated with a prepaid tuition plan likely would be absent from a savings plan.

Ceiling on Reimbursements

Policies for reimbursing institutions under state prepaid tuition plans are not yet clear. Prepaid tuition plans guarantee benefits to students. They do not guarantee complete payment to institutions of their actual tuition charges. To limit disbursements, a state plan could be structured with ceilings on payments to institutions. A proposed plan in New Jersey would guarantee 90 percent of tuition charges with reimbursement to all institutions for the remaining 10 percent dependent on yields from investments. Another possibility would limit payments to the average undergraduate tuition charges at public four-year institutions. In this case, high-tuition institutions would have to absorb the difference. Yet another example would be limiting an institution's reimbursement to the average tuition charge at the institution. The institution, thus, would lose tuition revenue from students enrolled in high-tuition programs.

Absorption of Financial Deficiencies

A financial deficiency could arise if assets in a prepaid tuition plans were not sufficient to meet obligations to beneficiaries at existing tuition rates. The plan could resolve the situation by having institutions absorb the

deficiency, thereby incurring a loss of revenue. This could occur in at least three ways.

Discounted Reimbursements. The state could encourage or mandate designated institutions to accept available funds as full payment for a beneficiary's tuition. Losses in revenue would be limited according to the number of beneficiaries attending the institution. Lost revenue, however, could be recovered through tuition increases to other students.

Reduced Tuition. The state could mandate a reduction in tuition rates at public institutions to ensure that available funds cover current tuition. This would result in a capping or reduction of institutional revenue.

Reduced Appropriations. The state could provide direct appropriations to the plan. It could raise additional revenue, reallocate appropriations from noneducation activities, or reallocate appropriations from elsewhere in the post-secondary education budget. Reallocations from within the post-secondary education budget would result in reductions in appropriations for public institutions. Reductions in student financial aid programs also could occur.

Diversion of Enrollment

The scope and terms of a state plan could result in the diversion of enrollment within the state from some institutions or programs to others. Examples of how this could occur include the following.

From Private to Public Institutions. Plans could limit the use of benefits to public institutions. Experience in other states suggests that such restrictions are more likely in a prepaid tuition plan than in a savings plan. The effect could be to induce families to plan for an individual's attendance at a public rather than a private institution. Some states allow for proceeds of prepayment plans to be applied toward the cost of attending a private institu-

tion. Whether this neutralizes the inherent advantage of the public institutions is unclear.

From Two-Year to Four-Year Institutions. A prepaid tuition plan could adversely affect enrollment at two-year institutions even if they were included in the plan. Most existing state plans allow for use of benefits at community colleges or technical institutes. Because tuition costs are higher at four-year institutions, however, the monetary value of benefits used at four-year institutions is higher than the value of benefits used at two-year institutions. This disparity would create a financial incentive for attending four-year institutions.

From Low-Cost, Four-Year to High-Cost, Four-Year Institutions. State prepaid tuition plans so far have provided for the use of benefits at any public four-year college or university within the state. Significant differences in tuition rates, however, exist among institutions. In Minnesota, where tuition is higher at the University of Minnesota than at state universities, the value of tuition benefits from a plan also would be higher at the University of Minnesota. The disparity in value would create a financial incentive for attendance at the University of Minnesota.

From Low-Cost to High-Cost Programs. To date, state plans have made no distinction in the application of benefits to undergraduate programs. Programs within the same institution, however, have different tuition rates. Again, this would create an incentive for registration in high-tuition programs where the monetary benefits would be greatest.

SUMMARY AND CONCLUSION

For post-secondary institutions, the impact of a state plan would depend upon several factors beyond institutional control. These include the nature and features of a plan, the choices of attendance exercised by beneficiaries, and

implementation by the state. Comparisons of benefits, direct costs, and risks appear in Table 5.

Savings plans likely would apply to a wide range of institutions. Benefits would be spread accordingly. Restricting benefits to in-state institutions or to public, in-state institutions presumably would favor those institutions.

Prepaid tuition plans likely would be limited to public, in-state institutions, which presumably would gain enrollments. Higher monetary value of benefits could further induce enrollment at high-cost, four-year institutions. These institutions, however, could lose if payments from the plan fell short of actual tuition charges. Institutions could be forced to absorb financial deficiencies through ceilings on reimbursements, freezing of tuition rates, or loss of appropriations reallocated to the plan to cover a deficiency.

TABLE 5. COMPARISON OF PLANS FOR THEIR POSSIBLE IMPACT ON POST-SECONDARY INSTITUTIONS

	<u>Prepaid Tuition (Composite)</u>	<u>Savings Account (IRA Type)</u>	<u>Savings Bonds (Illinois Type)</u>
Benefits			
Stable or Higher Enrollment	Public four-year institutions.	Distributed among all in-state post-secondary institutions.	Distributed among in-state and out-of-state institutions.
Cost			
Administrative	Verification of beneficiaries' attendance; processing of certificates.	Verification of beneficiaries' attendance.	Verification of beneficiaries' attendance.
Risks			
Ceilings on Reimbursements	Possible in case investments do not return enough to meet current tuition rates at designated institutions.	Not applicable.	Not applicable.
Caps on Tuition Rates and Revenue	Possible at state institutions as way to control costs, thereby assuring that plan assets equal obligations.	Not applicable.	Not applicable.
Reduced Appropriations	Possible reallocation of appropriations from public institutions to cover deficiency in plan.	Not applicable.	Possibility in order to cover debt service.
Diversion of Enrollments	Possible inducements for shifts from private to public, two-year to four-year, and low-tuition to high-tuition institutions within state.	Perhaps shift to high tuition institutions because of funds available to students.	Perhaps shift to high tuition institutions because of funds available to students.

SOURCE: Minnesota Higher Education Coordinating Board.

CHAPTER VIII. IMPACT ON THE STATE

Either a saving incentive or a prepaid tuition plan could offer the government and residents of Minnesota some broad benefits. Either one also could present significant costs or risks. Several policies for post-secondary education and other areas also could be affected. This chapter examines the possible effects.

BENEFITS

Potential benefits of a plan to the state are broad and indirect. The most dramatic benefit would be to keep attendance at a post-secondary institution within the financial means of state residents. Alternatively, the impact could be psychological by reassuring residents that post-secondary education would remain affordable. To the extent that a plan would maintain educational opportunities, it presumably would help produce enlightened and productive citizens. Sustaining enrollments in order to maintain the strength of post-secondary institutions also might be considered a worthwhile objective.

COSTS

Direct costs, mostly administrative, would be more extensive with a savings plan than with a prepaid tuition plan. Both kinds of plans likely would entail indirect costs to the state in the form of tax expenditures, or foregone tax revenue.

Administration

Identifiable administrative costs to the state generated by savings accounts, savings bonds, and prepaid tuition plans are discussed below.

Savings Accounts. The major administrative cost associated with a dedicated savings account would be to verify that the proceeds are used for authorized purposes. The savings institution could perform the actual verification before releasing funds. In that case, the institution either would absorb the cost or recover it from the account in some manner. The state, however, still would have to prepare and distribute reporting forms. It also would have to maintain and audit records. State appropriations to agencies performing these functions likely would be required to cover the costs. Marketing costs associated with plans might be shared by the state and financial institutions.

Savings Bonds. Creation of state savings bonds in Minnesota could involve added costs to the state in the short term and have financial consequences in the long term, according to staff of the Department of Finance.

The state likely would absorb the administrative costs of issuing bonds. Further, the distribution, marketing, and sale of bonds to many small investors likely would increase the fees charged to the state by bond underwriters. The state has been selling its general obligation bonds in large blocks to underwriters who, in turn, have been selling them in large blocks, usually to institutional investors. Administrative costs for the bonds have been around \$7 per \$1,000. Offering bonds to many small investors could increase administrative costs by as much as 70 percent to \$12 per \$1,000. On a bond sale of \$50 million, thus, the extra \$5 would increase the cost to the state by \$250,000.

If the state paid a bonus for using proceeds at a post-secondary institutions within the state, funds likely would come from additional appropriations for debt service.

Use of long-term, zero-coupon bonds would be a departure for the state's debt management that could complicate or increase costs. The state presumably would have to schedule the issuance of education savings bonds regularly to meet

customer demand. Further, the larger the issue of such bonds, the greater would be the chance that the state would have to adjust schedules for other bond issues to avoid coinciding maturity dates. Either constraint on scheduling could force the state to issue bonds when interest rates are high rather than at more opportune times. Beyond this, current state policy is to repay debt rapidly in 15 years or less. To offer deeply discounted savings bonds for a young child, however, would require maturity of up to 18 years.

Prepaid Tuition Plans. Prepaid tuition plans enacted in various states are designed to be financially self-sufficient. A portion of the earnings from the investment of funds would be used to support operations. Administration of a prepaid tuition plan, thus, would not require appropriation of state funds unless the plan experienced financial difficulties.

Though a prepaid tuition plan might be self-sufficient, it likely would require creation of a new administrative structure in state government. At least three alternative arrangements are possible. One would be creation of an entity similar to the State Retirement System to manage accounts of participants. Another would be significant expansion of an existing agency such as the Higher Education Coordinating Board. A third alternative would be the creation of an entity with a governing board and a small staff that would contract with private firms for various services.

Investments, too, could be handled by one of several different entities. The State Investment Board, which has responsibility for investing funds in the State Retirement System, could receive the assignment. Alternatively, another agency could be given responsibility, or a private investment firm could perform the function under contract with the state.

Tax Expenditures

Either a saving incentive or a prepaid tuition plan could result in tax expenditures, or foregone tax revenue, by the state. Under a savings plan similar to an IRA, the expenditure likely would be an exemption of deposits and earned interest from the income tax. Foregone taxes, for example, on \$2,000 deposited in 1,000 new accounts held by families in an 8 percent tax bracket would be \$160,000. If the number of accounts grew over the years to 50,000, foregone taxes would be \$8 million plus 8 percent of interest earnings in the various accounts.

The analogy to IRAs is limited, however. Taxes on IRAs are deferred, not entirely foregone. Discussion of favorable tax treatment for education financing plans focuses on complete deductibility of contributions, earnings, or both. Education savings plans with tax deductions or credits ultimately would result in greater foregone revenue to the state than plans with tax deferments.

Under a prepaid tuition plan, the tax expenditure would be less clear, but it could be more substantial. States with an income tax have chosen to view the plan as a contract rather than an investment. The increase in value between the purchase price and the ultimate tuition benefit in a prepaid tuition plan, thus, is not recognized as income. If the purchaser had instead placed the money in taxable savings accounts, stocks, or bonds, the interest earnings would have generated tax revenue. To the extent that a prepayment plan attracted money that would have gone into taxable investments, the state would be foregoing tax revenue from earnings on those investments.

RISKS

Risks to the state could be political and ethical as well as financial. Many risks appear to be more likely under a prepaid tuition plan than under other plans.

Attrition

In some prepayment plans, attrition rates could be an important element. Assets generated by individuals not claiming their benefits would help meet obligations to remaining beneficiaries. A plan under consideration in New Jersey assumes that 30 percent of named beneficiaries will not claim their full benefits. The chances of a deficit would increase if more named beneficiaries than anticipated were to attend designated institutions.

Including attrition as a factor in a plan might be awkward for the state in other ways. In effect, the state would be betting against the education plans of some residents. Viewed as insurance, a prepaid tuition plan makes post-secondary education an unwelcome event against which the state is willing to provide coverage.

Investments

Prepaid tuition plans rely on the investment of contributions or premiums to generate sufficient earnings to cover the cost of tuition for beneficiaries when they attend a post-secondary institution. Investments, however, involve risk that returns will not be sufficient to meet an investor's goals or needs. Risk rises in proportion to length of the investment period and the volatility of the investment instrument.

Returns on investment must equal or exceed the rate of increase in tuition to assure that a plan has sufficient funds to cover the cost of tuition in the future. Return and risk in investment instruments such as common stocks, long-term corporate bonds, long-term government bonds, and U.S. Treasury bills vary considerably. Historically, common stocks have produced the greatest return. Between 1926 and 1985, their average annual rate of return was 9.8 percent. Stocks, however, are subject to short-term fluctuations that result in no earnings or even losses on a year to year basis. This poses a risk that

interest earnings or cash value of stock might be too low to meet an investor's financial obligations that coincide with a declining stock market. Returns on long-term bonds and U.S. Treasury bills have been significantly lower than returns on common stocks. Between 1926 and 1985, average annual returns have been: long-term corporate bonds, 4.8 percent; long-term government bonds, 4.1 percent; and U.S. Treasury bills, 3.4 percent. Over the short term, however, returns from these instruments are less volatile than returns from common stocks.²⁵

Increases in tuition may exceed returns on various investments over a given time. The data in Table 6 illustrate this. From 1971 through 1985 average annual increases in tuition at Minnesota's public collegiate systems equaled or exceeded the average annual return on long-term bonds and U.S. Treasury bills. Returns on common stocks exceeded tuition increases, but in some cases only by a slim margin.

Returns on investments, moreover, may be volatile. Table 6 shows the ranges in annual tuition increases in Minnesota's public colleges and in annual returns on various investments from 1971 through 1985. Negative figures indicate loss in value. While returns on investments may exceed increases in tuition in some years, tuition increases may exceed returns in other years. Further, tuition has increased or remained stable in every year, while various investments, except for U.S. Treasury bills, have actually lost value in some years.²⁶

Retirement plans with predetermined benefits take advantage of a clear investment goal and time to accumulate funds to achieve it. With predetermined

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²⁵ Data of average annual rates of return are from Ibbotson Associates, Stocks, Bonds, Bills, and Inflation 1986 Yearbook: Market Results for 1926-1985 (Chicago: 1986), pp. 25, 95-103.

²⁶ Ibid., p. 28; Minnesota Higher Education Coordinating Board, Report to the Governor and the 1987 Legislature (St. Paul, 1987), p. 25.

TABLE 6. AVERAGE ANNUAL TUITION INCREASES IN MINNESOTA PUBLIC COLLEGIATE SYSTEMS, FISCAL YEARS 1971 THROUGH 1986, AND AVERAGE RETURN ON INVESTMENT OF VARIOUS INVESTMENT INSTRUMENTS, CALENDAR YEARS 1971 THROUGH 1985¹

	Average Annual Return or Tuition Increase	Range of Annual Return or Tuition Increase	
		High	Low
Return on Common Stock	10.5%	37.2%	-26.5%
Tuition Increase for Resident Undergraduates, State University System	10.0%	26.0%	0.0%
Tuition Increase for Resident Undergraduates, College of Liberal Arts, ² University of Minnesota	9.3%	22.1%	.6%
Tuition Increase for Resident Undergraduates, Community College System	8.5%	21.6%	0.0%
Return on Long-Term Corporate Bonds	8.5%	43.8%	-4.2%
Return on Long-Term Government Bonds	8.0%	40.4%	-4.0%
Return on U.S. Treasury Bills	7.9%	14.7%	3.8%

SOURCE: Ibbotson Associates, Stocks, Bonds, Bills, and Inflation 1986 Handbook (Chicago, 1986), pp. 94-103; Minnesota Higher Education Coordinating Board, Report to the Governor and the 1987 Legislature, (St. Paul, 1987), p. 25.

¹ Tuition includes tuition and required fees; public technical institutes excluded because they did not charge tuition until Fiscal Year 1979.

² Average of lower and upper division; does not reflect larger increases in other undergraduate units of the University of Minnesota.

benefits, the plan can anticipate the amount of money it will need at a given point in the future. Further, long durations before employee retirements enable plan managers to place contributions in high-yield investments like common stock to increase assets significantly without concern about short-term fluctuations. In addition, many plans have vesting periods, now commonly five years, before employees are eligible to receive benefits. Such plans have the use of contributions for the vesting period before an obligation actually is incurred.

Prepaid tuition plans likely would have a shorter investment period with less margin for error. This might not be a major problem if premiums for named beneficiaries were paid at birth and assets were allowed to accumulate for 18 years. The challenge of accumulating assets increases with the age of initial enrollment of the named beneficiary. If the investment period is brief, plan managers might not have the flexibility of retirement fund managers. Additional uncertainty would arise because the costs of benefits would be set externally by the post-secondary institutions shortly before beneficiaries attend.

Recent events underscore the risks. During October 1987, common stocks dropped over 20 percent in value. A prepaid tuition plan depending on returns from common stocks might not be able to retrieve sufficient funds to meet current tuition obligations. Further, losses in value might affect the ability to accumulate sufficient funds to cover obligations for the next few years.

Two scenarios for accumulating sufficient assets could arise. One would be to charge high premiums to be invested in low-risk, low-yield instruments. The other would be to charge low premiums to be invested in high-risk, high-yield instruments. Under the first scenario, high premiums might deter participation by families with little discretionary income. Low returns might deter participation by other families who on their own could obtain a better return on investment elsewhere. Under the second scenario, the risk of a financial deficiency for the plan would increase.

Pooling investments for state retirement plans and a prepaid tuition plan would be one approach to reduce risk. State law, however, prohibits the mingling of retirement funds and other funds.

Financial Deficiency

The state has essentially two ways to address a financial deficiency in a prepaid tuition plan. One is to guarantee sufficient assets in the plan to meet obligations. The other is to disclaim responsibility for any deficiency, thereby shifting the impact to the designated post-secondary institutions or the individuals participating in the plan.

State Guarantee. The state could provide direct support to the plan in the form of either a loan or a direct appropriation. Whether such a guarantee could be made in advance by statute is unclear. The state, however, could address deficiencies as they arise.

Appropriations to support a plan could come from two sources: reallocation of existing appropriations or additional tax revenue. Either would involve a direct subsidy by the taxpayers. Further, reallocation would involve reductions in funding elsewhere, including, perhaps, post-secondary institutions and student financial aid. In effect, all students, including those depending on financial aid, would pay for prepaid tuition. Raising additional tax revenue might be difficult, especially if the economic forces were the cause of low investment earnings. In that case, the same forces likely would have an adverse effect on state revenue collection to meet existing budgetary commitments.

Absorption by Institutions. The state could require the designated institutions in a plan to absorb a deficiency by mandating that institutions accept partial payments of tuition for beneficiaries. This could force institutions to raise tuition for everyone else in order to maintain revenues. Alternatively, the state could mandate lower tuition for everybody so that tuition charges

would equal the plan's resources. This could limit or reduce overall institutional revenue. In effect, the state would control the cost of attendance and expenditures by post-secondary institutions.

Absorption by Participants. Finally, the state could allow a prepayment plan to disband without providing full benefits. The Florida plan provides for this contingency. While premiums might be returned with some interest, the amount likely would not be sufficient to cover tuition costs. Named beneficiaries and their families, therefore, would assume responsibility for raising the money to pay tuition. Such a development, even if provided for in advance, likely would be disillusioning for the plan's participants and politically unpopular.

IMPLICATIONS FOR OTHER STATE PROGRAMS AND POLICIES

The prospect of a state plan for saving incentives or prepaid tuition raises questions about other state programs and policies. Several facets of post-secondary education could be affected, including student financial aid, institutional funding policies, and access to instructional programs. State policies on taxation, investment, and capital budgeting and bonding also could be affected.

Student Financial Assistance

Two issues related to financial assistance programs arise from consideration of saving incentive and prepaid tuition plans. One is reduced use of financial assistance programs as families accumulate resources to pay educational costs prior to actual attendance. The other is disincentives for families to save because other financial assistance might be lost.

A savings or a tuition prepayment plan might result in a reduction in student loans. Accumulation of savings or tuition credits prior to attendance

presumably would decrease a family's need to borrow money at the time of attendance. Borrowing might still occur, but at a lower volume.

Establishment of a state plan likely would not lead directly to reductions in the State Scholarship and Grant Program. Each activity would affect a different population. A saving incentive or a prepaid tuition plan would, in effect, be directed toward families with enough money to place in savings or to prepay tuition. Scholarships and grants, however, are directed toward families with low incomes. Few families with incomes low enough to qualify likely would be in financial position to participate in a plan, though contributions could come from relatives or other benefactors with financial resources.

Some frugal families might receive lower financial aid awards because of their assets. Other families who do not save might be rewarded with financial aid for not saving. To reduce these confusing signals, the state could eliminate all or a portion of savings from consideration as assets of applicants for financial aid. Illinois has done this with its savings bond program. Alternatively, the state could attribute ownership of the asset to the student rather than to the parent. This would reduce the parents' expected contribution toward the cost of attendance, thereby increasing the chances for an award. Benefits from a prepaid tuition plan might be more difficult to address in a similar manner. Those benefits would result in an actual reduction in the current cost of attendance, thereby increasing the expectation that other resources would cover the remaining cost.

Exemption of certain assets from need analysis could create additional administrative and regulatory burdens for state agencies. Allowing exemptions for parental assets would require revisions in the methodology used in awarding state scholarships and grants. Assets in the student's name already are exempt. Designating assets subject to exemption also would require some effort. Presumably, only assets in an approved plan or in an account in an approved

institution would be designated. This would require rules and procedures for approving accounts and verifying assets in them.

Beyond this, recent changes in federal law could create difficulties for need analysis. Amendments in 1986 to the Higher Education Act changed the manner in which the federal government determines expected contributions from families and students toward the cost of attendance. As a result, the federal government and Minnesota have different methods for making awards from their financial aid programs. Accommodating a state savings or prepaid tuition plan could complicate the resolution of these differences.

Tuition and Appropriations Policies

Financial deficiencies in a prepaid tuition plan could result in the state reducing tuition revenue at institutions. In at least two ways this could lead to revisions in state funding policies for the public post-secondary systems.

Balance between Appropriations and Tuition Revenue. Funding a deficiency could effectively change the statutory balance between state appropriations and tuition revenue. In the collegiate systems, appropriations are supposed to cover 67 percent of instructional costs and tuition revenue 33 percent. In the technical institutes, the respective figures are 74 percent and 26 percent. Reduction in tuition revenue without a proportional reduction in appropriations would increase the percentage covered by appropriations.

Different Treatment of Systems. Funding a deficiency also could result in different treatment of the systems. The greatest reduction in tuition revenue would occur where most beneficiaries attend. Thus, if most beneficiaries were to attend four-year institutions, the State University System and the University of Minnesota would experience greater losses than the other systems.

Access to Instructional Programs

The state's obligation to provide access to instructional programs could become an issue with a prepaid tuition plan. Limitation to undergraduate instruction is assumed. Named beneficiaries might face a dilemma if desired programs were not available at any of the plan's designated institutions. They either would have to forego their planned program of study in order to receive their benefits by attending a designated institution; or they would have to forego their benefits in order to pursue their desired studies.

The issue could be more difficult because of program termination. At the time of initial purchase, participants in the plan might feel entitled to access to all programs currently offered at designated institutions. Termination of a program that a named beneficiary wished to enter might then be viewed as a violation of a contractual obligation on a moral, though perhaps not a legal, level.

Several options for the state would be available.

- o Strict adherence to an institutionally oriented prepayment plan without regard to programs desired by named beneficiaries.
- o Prohibition on program termination without the consent of named beneficiaries in the prepayment plan.
- o Expansion of choice through extension of benefits to institutions in neighboring states covered by the terms of tuition reciprocity agreements.
- o Extension of benefits to cover tuition at an institution offering a program not available at a designated institution.
- o Establishment of all possible instructional programs among the designated institutions.

Taxation

Either a saving incentive or a prepaid tuition plan could provide favorable treatment on state income taxes through deductions or credits. Creation of new tax breaks, however, would counter recent trends in state policy. It would

complicate the filing of tax returns after attempts at simplification. It also might be perceived as a new tax shelter after attempts have been made to reduce the number of tax shelters.

Investments

Responsibility for investing funds in a prepaid tuition plan could be placed in one of several entities, including the State Investment Board. Placing it with the Investment Board, however, would add a new dimension to the Board's investment goals. This, in turn, might require modifications in the Board's investment policies and strategies.

Capital Budgeting and Bonding

Establishment of state savings bonds could complicate capital budgeting and bonding policies. A well received plan could result in demand for a steady stream of bonds. This would pose no problem under three conditions: first, if the state were to undertake a steady stream of capital projects generating bond issues regularly over several years, as Illinois plans to do; second, if the issue of bonds were to coincide with cash-flow needs for the projects; and third, if the issue of bonds were to coincide with favorable conditions in capital markets. In the absence of these conditions, the state might face the choice of reducing the savings bond program or issuing bonds to satisfy the program under unfavorable circumstances.

SUMMARY AND CONCLUSION

For the state, the potential benefits of a plan would be broad and indirect. These include alleviating concern about the ability to pay the cost of attending a post-secondary education and promoting the education of the state's residents.

A plan would involve several financial costs and risks for the state. Favorable tax treatment under any type of plan would result in foregone state revenue. Savings plans based on savings accounts would involve additional administrative costs related to regulation of accounts and verification of appropriate use of funds. Use of savings bonds would involve additional costs of marketing, distribution, and, if incorporated, bonuses for specified uses. Prepaid tuition plans would require the investment of funds with the clear risk that returns might not be sufficient to cover future obligations to make tuition payments.

The risks of financial deficiency in a prepaid tuition plan also would have political dimensions. In case the plan's assets were insufficient to meet obligations, the state would have to take one or more of the following actions that might undermine its credibility:

- o raise additional taxes,
- o raise premiums charged to current participants,
- o reallocate funds from other programs,
- o reduce tuition payments or appropriations to institutions, or
- o renege on benefits promised to beneficiaries.

Establishment of a state plan for saving incentives or prepaid tuition could affect other state programs and policies for post-secondary education. Either plan ultimately could result in less reliance on student loans by middle-income families. Demand for need-based scholarships and grants might not decline because low income families likely would not participate extensively in a plan. Nevertheless, changes in the need analysis for student financial aid might be implemented to reward frugal, low-income families who do participate.

Institutional financing policies might be undermined because of deficiencies in a prepaid tuition plan. Forcing institutions to absorb such

deficiencies might alter the current balance between tuition revenue and state appropriations within institutions or systems. The uneven distribution of a plan's participants also could result in some systems losing proportionally more tuition revenue than others.

The state's obligation to provide access to instructional programs for beneficiaries of a prepaid tuition might become an issue. If desired programs were not available at designated institutions or were terminated, the state might be called upon to guarantee that beneficiaries have access in some manner to those programs.

The impact of a plan could extend beyond post-secondary education to areas such as taxation, investment, and capital budgeting and bonding. Provision of new tax breaks would reverse recent trends toward simplification of Minnesota's income tax. Responsibility for managing investments for a prepaid tuition plan could force changes in the state's investment policies and strategies. A state savings bond program could lead to modifications in the state's practices related to the timing of capital budgets and issuance of general obligation bonds.

Table 7 compares the impacts on the state of a prepaid tuition plan, a savings account plan, and a savings bond plan.

TABLE 7. COMPARISON OF PLANS FOR THEIR POSSIBLE IMPACTS ON STATE GOVERNMENT

	<u>Prepaid Tuition (Composite)</u>	<u>Savings Account (IRA Type)</u>	<u>Savings Bonds (Illinois Type)</u>
Benefits			
Improved Affordability of Post-Secondary Education	Possible.	Possible.	Possible.
Costs			
Administration	None; plan to be self-sufficient.	Approval, regulation, and verification of use.	Increased cost of bond sales.
Tax Expenditures	Loss of taxes on contributions and investment returns.	Loss of taxes on contributions and investment returns.	No loss of revenue; state bonds already tax-exempt.
Risks			
Attrition	Might not be as high as anticipated, thereby causing deficit in plan.	Not applicable.	Not applicable.
Insufficient Return on Investment	Difficulty of return on many investments keeping pace with tuition increases; possibility of deficit in plan.	Not applicable.	Not applicable.
Covering Financial Deficiency	Five alternatives: 1) increase taxes, 2) increase premiums, 3) reallocation of appropriations from existing programs, 4) reduced funds to post-secondary institutions, 5) loss of benefits to plan participants.	Not applicable.	Part of obligation to redeem bonds.
Impact Elsewhere			
Student Financial Aid	Perhaps less demand for loans in future; pressure to modify measurement of family assets.	Perhaps less demand for loans in future; pressure to modify measurement of family assets.	Perhaps less demand for loans in future; pressure to modify measurement of family assets.
Post-Secondary Financing Policies	Possible distortion of tuition and appropriations policies for public institutions.	No apparent impact.	No apparent impact.
Access to Programs	Question of providing access to beneficiaries.	Possible issue; depends on designated institutions.	No apparent impact.
Tax Policy	New deduction for contribution possible.	New deduction for contribution possible.	No change.
Investment Policy	Different strategies from pension investments.	Not applicable.	Not applicable.
Capital Budget and Bonding	Not applicable.	Not applicable	Possible changes in project timing and debt management.

SOURCE: Minnesota Higher Education Coordinating Board.

CHAPTER IX. CONCLUSION

Costs and risks raise serious questions about a state prepaid tuition or savings plan. The concept and prospective benefits of various plans are attractive. The state, however, needs carefully to consider potentially adverse consequences. The greater the participation in a plan, the greater would be the costs and risks. Low participation, in contrast, might make a plan unjustifiable. Proposals of federal plans and the appearance of private plans raise further uncertainties about state action. Establishment of a plan would not drastically change the family's role in financing post-secondary education. By itself, a plan would not greatly reduce the demand for need-based student financial aid. It also would not eliminate the responsibility of families and individuals to finance the cost of attendance.

PREPAID TUITION

A state plan for prepaid tuition would place many parties at risk financially and in other ways. Only if the rate of return on funds invested in the plan were identical to rates of increase in tuition would direct financial risk diminish. Even then, questions would arise about the need for the state to manage investments for individuals who might be able to obtain equal returns elsewhere.

Risk of a loss would exist if the plan were to have either a surplus or a deficiency. A surplus would imply that returns on investment were higher than increases in tuition. In that case, participants would lose the difference between the return that they could have obtained on their own and the return that they actually would receive in increased value of tuition.

If a deficiency were to occur, someone would have to pay. Early participants might lose benefits. New and continuing participants might pay higher premiums, which would increase direct outlays as well as reduce the potential return on investment. Post-secondary institutions might face caps on reimbursements or constraints on tuition revenue and appropriations. Other students enrolled at the time of a deficiency might have to pay higher tuition to meet an institution's revenue expectations. The state and its residents might have to pay in the form of higher taxes or transfer of funds from other programs.

Serious educational risks would be associated with a prepaid tuition plan. Prospective students might feel obligated to attend an institution inappropriate for their needs in order to use their benefits. Institutions might be adversely affected either by the diversion of students elsewhere or the enrollment of students not likely to benefit from institutional programs. For its part, the state might feel obliged to provide a more extensive selection of instructional programs to meet demand of a plan's participants.

The state would face political risks. Allowing participants to lose benefits because of a deficiency might be viewed as breaking an implied promise regardless of legal disclaimers. Providing state funds to remedy a deficiency would be breaking a promise not to make the state financially liable for the plan. Moreover, by rescuing the plan, the state, in effect, would be operating a guaranteed investment fund for individuals who have the money to invest. Adjusting tuition and institutional appropriations to resolve financial problems of a prepayment plan might adversely affect other state policies. In effect, the financial requirements of the plan rather than educational or other budgetary considerations would drive the financing of post-secondary education.

SAVINGS BONDS

Savings bonds would provide financial opportunities with little risk for participants. While the accumulated assets might not meet an individual's entire cost of attendance, they could meet much of it. Flexibility in the use of funds, moreover, would maintain or expand educational choice for individuals. At the same time, post-secondary institutions would face little apparent risk of the plan diverting enrollments from some institutions at the expense of others. Further, there would be little evident impact on other state policies for post-secondary education.

The bonds, however, would be only one of several investments available to families. Attractiveness of tax-exempt bonds would fluctuate with their return compared to the after-tax returns from other investments. The objectives of the state and participants in a savings bond program would not necessarily coincide. As investors, participants typically would buy bonds with the highest possible interest rates in order to maximize returns. The state, in contrast, typically would sell bonds at the lowest possible interest rates to minimize its expenditures for debt service.

Questions about state savings bonds largely involve financial costs and risks to the state. Widespread marketing and sale of bonds would involve some administrative expenditures. To the extent that state residents shifted their investments from taxable instruments into tax-free municipal bonds, the state would lose tax revenue on interest earnings. Higher interest rates also might result from unfavorable timing of bond sales. Beyond this are the risks that a savings bond program might influence the state's capital budget and debt management policies, which, in turn, might adversely affect the state's bond ratings.

SAVINGS ACCOUNTS

A savings account plan would provide benefits similar to those provided by savings bonds. Significant costs and uncertainties, however, cast doubt on the practicality of a state-sponsored savings account. A plan likely would feature tax exemptions or credits. This would reverse recent trends away from special tax treatment, and it would force the state either to accept lower tax revenue or to shift the tax burden to other taxpayers. It also would require the state to approve and regulate accounts that could be used for post-secondary education.

The absence of favorable tax treatment by the federal government likely would be a major impediment to widespread participation in a state plan. Federal tax rates are higher than state tax rates; hence, tax breaks are more valuable at the federal level than at the state level. Experience indicates that few individuals would respond to a savings plan that offered tax advantages only at the state level.

UNCERTAINTY ABOUT FEDERAL POLICIES

Prospects for adoption of a federal savings plan are uncertain. Members of Congress and other national political leaders are interested in such plans. The large federal deficit, however, leaves virtually no room for new programs requiring additional appropriations or tax expenditures, unless funds are shifted from other programs. Significant tax expenditures, moreover, might not appear for several years. A decision on the issue might have to await the outcome of the 1988 elections, from which a new set of national priorities might emerge.

Adoption of a state plan before the federal government acts would involve some risks. If the state and the federal government established separate plans, the differences might create confusion and pose other difficulties for families

participating in both. At the extreme, the two plans might diverge so much as to be incompatible. They then might compete with each other directly for participants.

OTHER PUBLIC AND PRIVATE SAVINGS OPTIONS

Families and individuals can save for a post-secondary education using existing financial instruments. The finance industry offers a variety of options for individuals to use in pursuit of their financial goals. Instruments such as savings accounts, stocks, bonds, life insurance, and annuities may be used to save for education or any other purpose. Government bonds and securities also are available to individuals wishing to save. Some of these instruments offer tax advantages.

Private organizations have been developing financial products dedicated to post-secondary education. In large part, this trend may be a response to interest in prepaid tuition and saving incentive plans. These products typically incorporate existing financial instruments with additional features or services to help families and individuals plan for educational costs. The appearance of these products raises questions about the need for an initiative by state government.

NO SUBSTITUTE FOR FINANCIAL AID

No plan, state or federal, saving incentive or prepaid tuition, would be a substitute for need-based student financial aid. Establishing a plan with the objective of diminishing or eliminating programs would be misguided. Most participants would be from families affluent enough to afford the contributions and young enough to have a reasonable period of time for accumulating assets. Few families with annual incomes low enough to qualify for financial aid likely would be in a position to contribute more than nominal amounts to a plan. For

those few families, however, adjustments in qualifications for receiving student financial aid from the state might be desirable.

RESPONSIBILITY OF FAMILIES AND INDIVIDUALS

Financing the cost of attending a post-secondary institution is a responsibility of families and individuals. Saving is one means of financing that reduces the burden on current income and reliance on loans. The more a family saves and the earlier it begins to save, the more money will be available at the time of attendance. The commitment by families and individuals to save remains essential for this effort with or without a state plan. A special saving incentive or a prepaid tuition plan is not necessary for saving toward post-secondary education. For many families, however, such a plan, whether sponsored by the state, the federal government, or the private sector, might help focus these efforts.

APPENDIX A. ADVISORY COMMITTEE

The following individuals served on the advisory committee for the study of saving incentive and prepaid tuition plans:

Howard Bicker
Executive Director
Minnesota State Board of Investment

Douglas Easterling
Director of Planning and Research
Minnesota Community College System

Amy Eisenstadt
Attorney
Minnesota Department of Revenue

Phyllis Ethridge
Assistant Vice Chancellor for Student Affairs
Minnesota State University System

John Jackson
Vice President and General Counsel
Minnesota Bankers Association

Ross Levin
President
Twin Cities Association for Financial Planning

Robert Misenko
President
Minnesota Association of Financial Aid Administrators

Diane Paulson
Finance Specialist
Minnesota State Board of Vocational Technical Education

Lori Roth
Student Advisory Council

Rick Smith
Vice President
Minnesota Private College Council

Lois Strand
Minnesota Association of Private Post-Secondary Schools

William Weiler
Associate Director, Management Planning and Information Services
University of Minnesota

Barbara Zohn
President
PTA-PTSA of Minnesota

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Inquiries regarding compliance may be directed to Office of Personnel and Affirmative Action, Minnesota Higher Education Coordinating Board, 400 Capitol Square, 550 Cedar Street, St. Paul, MN 55101, (612) 296-3974.

**Minnesota Higher Education
Coordinating Board**

Suite 400, Capitol Square Building
550 Cedar Street
St. Paul, Minnesota 55101
612-296-3974